[JOINT COMMITTEE PRINT]

GENERAL EXPLANATION
OF THE
REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984

(H.R. 4170, 98TH CONGRESS;
PUBLIC LAW 98-369)

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

DECEMBER 31, 1984

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CONGRESS OF THE UNITED STATES

(98TH CONG., 2D SESS.)

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LETTER OF TRANSMITTAL

U.S. CONGRESS,
JOINT COMMITTEE ON TAXATION,
Washington, D.C., December 31, 1984.

Hon. ROBERT DOLE, *Chairman,*
Hon. DAN ROSTENKOWSKI, *Vice-Chairman,*
Joint Committee on Taxation,
U.S. Congress, Washington, D.C.

DEAR MESSRS. CHAIRMEN: This document, the General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, was prepared by the staff of the Joint Committee on Taxation, in consultation with the staffs of the House Committee on Ways and Means and the Senate Committee on Finance. It is comparable to similar material prepared by the Joint Committee staff with respect to other major revenue acts in recent years.

A committee report or print on legislation issued by a Congressional committee sets forth the committee's explanation of the bill as it was reported by that committee. In some instances, a committee report or print does not also serve as an explanation of the final provisions of the legislation as enacted by the Congress. This is because the versions of the bill reported or approved by the House and Senate committees may differ significantly from the versions of the bill as passed by the House, as passed by the Senate, or as enacted after action by a conference committee.

The Tax Reform Act of 1984, because of its comprehensive scope and the numerous changes which were made to the bill by the Senate and the conference committee, is an example of legislation with respect to which the differences between provisions of the reported bills or committee amendment and provisions of the public law are significant. The Tax Reform Act of 1984 is Division A of the Deficit Reduction Act of 1984 (P.L. 98-369). In addition, Division B (Spending Reduction Act of 1984) of the Act includes several tax-related provisions (described in this document) within the jurisdiction of the Committee on Ways and Means and the Committee on Finance.

The first part of the document is an overall chronology of the legislative background of the revenue provisions of the Act in the 98th Congress. (In addition to this overall chronology, specific references to the legislative background of each provision of the Act are set forth in footnotes accompanying the explanations of the provisions in the third and fourth parts of the document.) The second part presents the general reasons for the legislation. The third part consists of explanations of the revenue provisions of the Act (Division A). The fourth part consists of explanations of other tax-related provisions of the Act (included in Division B of the Act). An appendix sets forth the estimated budget effects of the provisions of the Act described in the document for fiscal years 1984-1989.

Sincerely yours,

DAVID H. BROCKWAY,
Chief of Staff.

I. LEGISLATIVE HISTORY

The following is an overall chronology of the legislative background in the 98th Congress of the revenue provisions of H.R. 4170, the Deficit Reduction Act of 1984 (Public Law 98-369).[1]

A. House Action

H.R. 4170

H.R. 4170 as originally reported

H.R. 4170 was introduced and was ordered to be reported on October 20, 1983, to incorporate the markup decisions of the House Committee on Ways and Means on various introduced tax bills and other amendments. A report was filed on H.R. 4170 on October 21, 1983 (H. Rep. No. 98-432).[2] In addition to seven tax titles, H.R. 4170 as reported included the Social Security Disability Benefits Reform Act of 1983, the Medicare Budget Reconciliation Amendments of 1983, and trade assistance amendments.

On November 16, 1983, the House Rules Committee granted a modified open rule (H. Res. 376) for consideration of H.R. 4170, which rule failed of passage on November 17, 1983.

H.R. 4170 Committee amendment

On March 1, 1984, the Committee on Ways and Means approved a Committee amendment as a substitute for H.R. 4170 as originally reported. The Committee filed a supplemental report on its amendment on March 5, 1984 (H. Rep. No. 98-432, Pt. 2).[3]

The Committee amendment included nine tax titles plus the Social Security disability, Medicare, and trade assistance titles. On March 7, 1984, the House Rules Committee granted a modified closed rule on H.R. 4170, making the Ways and Means Committee amendment (without the three nontax titles) in order as a substitute for H.R. 4170 as originally reported (H. Res. 462). The House adopted the rule on April 11, 1984, and passed the bill with the

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[1] In addition to this overall chronology, specific references to the legislative background of each revenue provision are set forth in footnotes accompanying the explanation of the provisions in Parts III and IV of this document. These legislative background references include, as appropriate, citations to the following: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984 (H. Rep. No. 98-432, Pt. 2; March 5, 1984); "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984 (S. Prt. 98-169, Vols. I and II; April 2, 1984); Senate floor amendments, if any, to H.R. 2163 (added to H.R. 4170 before sending H.R. 4170 to conference); the Conference Report on H.R. 4170 (Joint Explanatory Statement of the Committee of Conference) (H. Rep. No. 98-861; June 23, 1984); and H. Con. Res. 328, which directed the enrolling clerk to make certain technical and clerical corrections to H.R. 4170.

[2] Fourteen bills, as amended, were incorporated along with other Committee amendments into H.R. 4170 as reported. For more details on the legislative history of the Ways and Means Committee and Subcommittee hearings and markups on these bills, see H. Rep. No. 98-432, pt 2, pp. 11-13.

[3] For more details on the legislative history of the Committee hearings and markup on the Committee amendment, see the Supplemental Report, pp. 1025-28.

Committee amendments, including a technical amendment, by a vote of 318-97 on April 11, 1984. H.R. 4170 was received in the Senate on April 26, 1984, and placed on the Senate Legislative Calendar (Senate Calendar No. 800).

H.R. 2163

H.R. 2163, the Sport Fish Restoration Act of 1983, was introduced on March 16, 1983, and referred to the House Committee on Merchant Marine and Fisheries. The Subcommittee on Coast Guard and Navigation marked up the bill on April 20, 1983, and forwarded the bill (adding amendments relating to the Federal Boat Safety Act of 1971) to the full Committee on Merchant Marine and Fisheries on April 20. The full Committee marked up the bill on May 10, 1983, and reported the bill as amended on May 16, 1983 (H. Rep. No. 98-133, Part 1).

H.R. 2163 was sequentially referred to the Committee on Ways and Means for a period ending July 15, 1983. The Ways and Means Committee held a hearing on June 2, 1983, and marked up the bill on June 29, 1983. The bill was reported by the Ways and Means Committee with an amendment in the nature of a substitute on July 1, 1983 (H. Rep. No. 98-133, Pt. 2).[4]

On July 12, 1983, the House by voice vote suspended the rules and passed H.R. 2163, as amended by the Ways and Means Committee. Thus, as passed by the House, the bill related primarily to the Sport Fish Restoration and Federal Boat Safety Programs, and the excise taxes on sport fishing equipment and motorboat fuels that finance these programs. The House-passed bill also included provisions relating to the excise tax on certain arrows and the tax-exempt status of the proposed National Fish and Wildlife Foundation (contained in a separate bill, H.R. 2809, subsequently enacted in P.L. 98-244).

B. Senate Action

S. 2062

The Senate Committee on Finance approved its fiscal year 1984 budget reconciliation recommendations (revenue and spending provisions) on October 31, 1983, and transmitted bill and report language on that date to the Senate Budget Committee. The Budget Committee included the Finance Committee's revenue and spending recommendations as title I (Deficit Reduction Tax Act of 1983) of S. 2062 (Omnibus Reconciliation Act of 1983) as reported by the Budget Committee on November 4, 1983 (S. Rep. No. 98-300). S. 2062 was placed on the Senate Calendar on November 16, 1983, was considered on November 16-17, 1983, and was returned to the Calendar on November 18, 1983.

[4] The bill was then sequentially referred to the Committee on Interior and Insular Affairs for a period ending July 11, 1983. The Interior Committee was discharged by motion on July 11, and the bill was placed on the House Calendar on July 11, 1983.

H.R. 2163

1983 consideration

H.R. 2163, as passed by the House, was referred to the Senate Finance Committee on July 13, 1983. A hearing was held on August 3, 1983, by the Finance Subcommittee on Taxation and Debt Management. The substance of the bill (with amendments)[5] was included in the Finance Committee revenue reconciliation proposal in S. 2062 as reported.

The Finance Committee then marked up H.R. 2163 on November 7, 1983, and reported it on November 15, 1983 (S. Rep. No. 98-312), substituting miscellaneous trade and tariff matters from S. 230, S. 453, and S. 759 for the House-passed revenue provisions.

1984 consideration

Finance Committee markup.—The Finance Committee marked up its deficit reduction (revenue and spending) proposals on February 23, 28-29, and March 1, 7-8, 13-15, and 20-21, 1984, with Committee approval on March 21 of a deficit reduction proposal. The Finance Committee printed an explanation and statutory language of its deficit reduction proposal on April 2, 1984 (S. Prt. 98-169, Vols. I and II). The deficit reduction proposal included the revenue and spending provisions of S. 2062, with further amendments, as well as new provisions.

Senate floor action.—The Finance Committee deficit reduction proposal (revenue and spending provisions) was considered as a floor amendment to H.R. 2163, beginning on April 5, 1984, and continuing on April 9-12, 1984. The amendment, as amended by further Senate floor amendments, was approved on April 12, 1984, by a record vote of 76-5.

The Senate continued floor debate on spending-related amendments to H.R. 2163 on April 24-26, and 30, and May 1-3, 8-11, and 14-17, 1984.

H.R. 4170

The provisions of H.R. 2163, as amended by the revenue provisions (Deficit Reduction Tax Act of 1984) and the spending-related provisions, were substituted by the Senate as an amendment to H.R. 4170 on May 17, 1984, and passed by a record vote of 74-23.

C. Conference Action

Conference

On May 17, 1984, the Senate insisted on its amendments and asked for a conference. Conferees appointed with respect to the revenue provisions were the following: Senators Dole, Packwood, Roth, Danforth, Chafee, Long, Bentsen, Matsunaga, and Baucus. On May 23, 1984, the House requested a conference and appointed the following as conferees with respect to the revenue provisions: Representatives Rostenkowski, Gibbons, Pickle, Rangel, Stark, Conable, Duncan, and Archer. Also on May 23 by unanimous consent, the

[5] Except for the provision relating to the tax-exempt status of the National Fish and Wildlife Foundation.

House added a further amendment to the House-passed H.R. 4170 relating to certain spending reduction provisions. On May 24, 1984, the Senate disagreed to the further House amendment and agreed to a conference on the bill.

Conference was held on the revenue provisions on June 6-8, 12, 14-15, and 18-23, 1984. The conferees filed a conference report on H.R. 4170 on June 23, 1984 (H. Rep. No. 98-861). The Act was divided into Division A, Tax Reform Act of 1984, and Division B, Spending Reduction Act of 1984.

House-Senate consideration of conference report

The conference report on H.R. 4170 was passed on June 27, 1984, by a vote of 268-155 in the House, and by a vote of 83-15 in the Senate. A Concurrent Resolution (H. Con. Res. 328), to provide technical and clerical corrections to H.R. 4170, was passed by the House (voice vote) on June 27, 1984. H. Con. Res. 328 was amended and passed by the Senate (voice vote) on June 29, 1984, and was approved by the House (voice vote) as amended on June 29, 1984.

D. Enactment of H.R. 4170

H.R. 4170, the Deficit Reduction Act of 1984, was signed into law by President Reagan on July 18, 1984 (Public Law 98-369).

E. Subsequent Related Tax Legislation

Subsequent to enactment of Public Law 98-369, Congress passed two tax bills which included provisions relating to certain tax provisions included or considered in the Tax Reform Act of 1984: H.R. 2568 (relating to educational assistance plans) and H.R. 5361 (relating to group legal services plans and imputed interest on sales of real property).

H.R. 2568 was signed by the President on October 31, 1984 (P.L. 98-611).[6] H.R. 5361 was signed into law by the President on October 31, 1984 (P.L. 98-612).

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[6] A Senate amendment to H.R. 4170, which was not agreed to by the conference committee, would have extended the previous section 127 exclusion through 1985. See section 890 of the Finance Committee amendment approved on March 21, 1984; S. Prt. 98-169, Vol. I., pp. 779-781.

II. GENERAL REASONS FOR REVENUE PROVISIONS

Despite the recovery of the U.S. economy in 1983, Congress was concerned that the budget deficits projected by both the Office of Management and Budget and the Congressional Budget Office would threaten continued economic growth and investment at a low rate of inflation. The main objective of the Tax Reform Act of 1984 was to reduce these budget deficits in order to safeguard the economic recovery. A related objective was to prevent further erosion of the tax base as a result of tax sheltering activity. The budget deficit has been aggravated by the growth of tax shelter partnerships and the use of structural tax rules in a way that achieves tax benefits far in excess of those intended by Congress. Additional objectives were to ensure that all taxpayers pay a fair share of the tax burden, to reform the taxation of international income, and to improve the administration and efficiency of the tax system. Finally, the Act was designed to provide tax incentives for certain investments to promote continued economic growth.

Deficit Reduction

Background

In February 1984, the Congressional Budget Office estimated that current fiscal policy would produce a substantial growth in the Federal deficit from $195 billion in fiscal year 1983 to $326 billion in 1989. Furthermore, an increasing portion of the budget deficit appeared to be attributable to structural features of tax and spending programs rather than adverse cyclical conditions.

The Congressional Budget Office estimated that the structural budget deficit would more than double relative to gross national product (GNP), from 2.4 percent in 1983 to 5.5 percent in 1989. This rising stream of deficits was projected to add more than $1.5 trillion to the national debt over the 1984–89 period, increasing Federal borrowing from one-third to one-half of GNP. The cost of servicing the debt was projected to increase from 11 percent to 16 percent of Federal budget outlays from 1983 to 1989, which would have made it even more difficult to cut the deficit in future budget cycles if no action was taken in 1984.

Congress believed that if action was not taken to reduce these budget deficits, it would have been more difficult to sustain real economic growth and price stability. If monetary policy continues to be anti-inflationary, the competition between public and private borrowing, as the economy aproaches full employment, will put upward pressure on interest rates. High real interest rates harm private capital formation and contribute to the appreciation of the dollar, relative to foreign currencies, which adversely affects the merchandise trade balance. The adverse effects of mounting budget deficits and high real interest rates were apparent in the deteriorating trade balance, which recorded a deficit in 1983 exceeding $60 billion.

In recognition of the deficit problem, the President proposed a $150 billion "down payment" on the budget deficit over three years. The Act includes revenue measures which raise $1.1 billion in fiscal 1984, $10.6 billion in 1985, $16.5 billion in 1986, and $22.5 billion in 1987, for a total revenue increase of $50.7 billion over the four-year period. Thus, the Act achieves approximately one-third of the deficit reduction target through revenue increases.

Tax provisions

The Act contains numerous provisions which are designed to reduce the budget deficit in a fair and equitable manner. The Act postpones ten tax reductions scheduled to take effect in 1984 and subsequent years. Congress believed that this postponement, which does not raise any taxes above their level at the end of 1983, is a fair way to reduce the deficit, and will cause far less disruption than the imposition of new tax increases.

Another important deficit reduction provision is an increase in the cost recovery period for new and used depreciable real property from 15 to 18 years. The highly accelerated depreciation deductions for real property provided under prior law, in conjunction with exemption from the "at-risk" rules, the general rules for accrual of interest on original issue discount debt, and the general recapture rules, contributed to the rapid growth of real estate tax shelters. The Act reduces the incentive to promote tax-oriented real estate partnerships, and to engage in other tax-motivated transactions such as the sale and leaseback of office buildings. However, the Act provides some protection for low-income families by exempting low-income housing from the extension of the depreciation period.

Insofar as possible, Congress attempted to meet its deficit reduction target without adversely affecting the average taxpayer or average program beneficiary. When provisions do affect the average taxpayer, this has been because Congress believed that prior law provided unnecessary or unintended benefits. For example, the Act modifies the income averaging formula because use of this provision has expanded dramatically in recent years, and the averaging threshold need not be as generous in view of the tax rate cuts and tax indexing enacted in 1981.

Much of the Act's deficit reduction involves the scaling back of unwarranted tax advantages for businesses. The Act eliminates certain tax benefits by broadening the definition of a corporation's earnings and profits to measure more accurately its economic income. This will prevent shareholders from avoiding tax on a portion of dividends in situations where the prior earnings and profits rules understated the corporation's economic income. Also, the Act increases the present-law reduction in certain corporate tax preferences from 15 to 20 percent, and requires corporations to capitalize, rather than expense, construction period interest and taxes on residential property other than low-income housing. The Act also reduces the tax benefits available to certain business property if 50 percent or more of the property's use is for personal purposes. This provision reduces the tax benefits claimed by taxpayers on property that is not used primarily in a trade or business.

Prevention of Tax Base Erosion

Congress believed that the proliferation of tax shelters had seriously eroded the tax base and adversely affected the efficiency and equity of the tax system. The increase in tax shelter activity had aggrevated the nation's deficit problem, particularly in the case of "abusive" shelters where the tax write-offs were several times larger than the equity investment. The proliferation of tax-sheltered investments shifts the tax burden to those taxpayers who do not or cannot participate in such investments, and the organization and promotion of tax shelters diverts thousands of skilled professionals from potentially more productive activities. Accordingly, the Act contains a number of provisions designed to eliminate unintended tax results achieved in certain partnership transactions.

Many tax shelter transactions derive unintended tax benefits by exploiting the Code's failure to take into account the time value of money. For example, the tax law has been slow to require economic accrual of interest on obligations issued at a discount. The Act requires the economic accrual of interest on deferred payments made in connection with the sale or exchange of property and services in certain transactions that are excluded under current law. This will limit the extent to which taxpayers can achieve substantial reductions in tax liability merely by changing the form in which property is sold. A related provision of the Act prevents the deferral of depreciation recapture in situations where depreciable property is sold using the installment method.

Another area where the tax base has been seriously eroded is the use of tax-exempt bonds for private purposes. In recent years, the use of such bonds has grown far beyond what was originally intended by Congress, and has significantly raised interest rates on the general obligation bonds that State and local governments issue to finance their operations. The Act limits the benefits of private purpose tax-exempt bonds in order to curb the uncontrolled Federal tax expenditure for private property financed with these bonds.

Congress was also concerned about the use of leasing and sale-leaseback arrangements by Federal agencies, State and local governments, and other tax-exempt entities in order to obtain the advantages of accelerated depreciation and other tax benefits. In these lease transactions, a portion of the tax benefit available to the lessor is passed through to the nontaxable lessee in the form of lower rents. Thus, the leasing arrangement allows tax benefits to flow through to nontaxable entities that are not eligible for them on their own account. The cost advantage of leasing versus purchasing property is a benefit which is effectively paid by the Federal government to the tax-exempt entity. Moreover, the cost to the Federal government is more than the benefit received by the tax-exempt entity—some of the benefits go to the lessor and to financial and other intermediaries. The Act eliminates the excessive tax benefits for property used by tax-exempt entities.

Tax Equity

Congress was concerned that the tax system should be as equitable as possible and, equally important, should be perceived by taxpayers as fair. Compliance with the tax law is likely to decline if taxpayers believe that the burden is unfairly distributed as a result of inequities in the tax system.

One inequity arose where employers provided employee benefits through the establishment of a tax-exempt employees' beneficiary associations (VEBAs). Some VEBAs were being used to allow employers to earn tax-exempt interest on excessive reserves. The Act limits the overfunding of welfare benefit plans merely to facilitate the deferral of income tax.

Congress was also concerned about the fairness of the tax system with respect to low-income households. Under limits established in 1979, low-income taxpayers were eligible for a refundable 10-percent credit on the first $5,000 of income ($500 maximum credit) which was phased-down to zero as income increased from $6,000 to $10,000. Since 1979, increases in the social security tax and the cost of living had increased the relative burden of the income tax on certain low-income households. The Act increases the earned income credit to 11 percent on the first $5,000 of income ($550 maximum credit), and the credit is phased out at an income of $11,000. This change provides relief to low-income taxpayers while preserving incentives to work. The Act also extends the targeted jobs tax credit through December 31, 1985. This provision benefits economically disadvantaged groups of workers that have historically experienced unemployment rates above the national average.

Congress believed that the structure of the taxation of life insurance companies should be fundamentally revised to ensure similar tax treatment of different segments of the industry. The Life Insurance Company Tax Act of 1959 (on which prior law was based) was designed to ensure that the life insurance industry as a whole paid a target amount of tax and that the distribution of this tax burden within the industry was balanced. The three-phase structure of prior law was extremely complex, and in the past few years the presence of high interest rates and new investment-oriented life insurance products has substantially redistributed the industry's tax burden. Congress believed that a simpler single-phase tax, more like that imposed on corporations in other industries, would ensure that life insurance companies face comparable tax burdens.

The Act reduces scheduled increases in the heavy vehicle use tax provided by the Surface Transportation Assistance Act of 1982 (Highway Revenue Act title). These changes were designed to distribute more equitably the burden of such taxes among users of the nation's highway system while maintaining adherence to cost allocation principles adopted in earlier legislation.

Taxation of International Income

The Act reforms numerous provisions of the Code concerning the taxation of income earned abroad by U.S. residents and the taxation of U.S.-source income earned by foreign investors.

The Act reforms the rules governing transfers of appreciated property to foreign corporations; in particular, the tax-free transfer of intangibles to foreign corporations. The Act also prevents improper use of the foreign tax credit to reduce U.S. taxes on U.S.-source income.

Under prior law, interest paid by a U.S. borrower to a foreign lender was generally subject to a 30-percent withholding tax. Some U.S. borrowers argued that treaty arrangements allowed them to borrow funds from foreigners free of the withholding tax. The Act eliminates the 30-percent tax on certain portfolio interest received by foreigners, and gives Treasury regulatory authority to prevent tax avoidance by U.S. residents receiving such interest.

Under prior law, the use of a Domestic International Sales Corporation (DISC) allowed deferral of corporate income tax on a portion of export-related income. The DISC system of taxation was an irritant in trade negotiations. The Act creates a new system of taxing the export income of foreign sales corporations (FSCs). The FSC system of taxation was designed to comply with the letter and spirit of the General Agreement on Trade and Tariffs (GATT) code, and to be revenue neutral compared to the DISC system.

Improved Tax Administration and Simplification

Congress examined numerous provisions of the tax law, and recommended simplification or administrative improvements in several areas.

The Act groups existing income tax credits into logical categories and provides uniform tax liability limitations and carryover rules. The Act simplifies the individual estimated tax rules and improves the administration of tax rules regarding alimony payments and the dependency exemption for children of divorced or separated parents.

The Act also includes changes in reporting requirements and penalties in order to improve compliance with the tax system. Congress believed that unless continued efforts were made to deter and punish noncompliance, the integrity of the tax system would be severely eroded. The compliance provisions in the Act complement and strengthen the compliance measures enacted in the Tax Equity and Fiscal Responsibility Act of 1982.

Incentives for Investment and Continued Economic Growth

Congress believed that the promotion of continued economic growth required a balanced tax program of deficit-reducing measures and tax incentives designed to stimulate research and capital formation. The Act extends the current suspension of Treasury regulations which require the allocation of research and experimental expenses between U.S. and foreign sources. This effectively lowers the U.S. tax liability of certain U.S. corporations that engage in research activities and pay relatively high foreign taxes. The Act also reduces the holding period for long-term capital gains from one year to six months, and provides a number of incentives for employee stock ownership plans (ESOPs).

President's Private Sector Survey on Cost Control

Congress believed that the President's Private Sector Survey on Cost Control (the "Survey") developed a number of important proposals for controlling Federal outlays and improving administrative practices. In an effort to increase government efficiency, the Act included two tax-related changes proposed in the Survey. First, the Act authorizes the Internal Revenue Service to offset delinquent nontax debts owed the Federal Government against Federal income tax refunds. Second, the Act authorizes and requires the Internal Revenue Service to make available data on unearned income to Federal and State agencies that administer means-tested Federal benefit programs, and requires States to collect quarterly wage data for purposes of income verification.

III. GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE ACT

TITLE I. TAX FREEZE; TAX REFORMS GENERALLY

A. Tax Freeze and Related Provisions

1. Investment Credit for Used Property (sec. 11 of the Act and sec. 48 of the Code)[1]

Prior Law

The maximum amount of a taxpayer's investment in used property that is eligible for the regular investment tax credit in a taxable year is $125,000 (sec. 48(c)(2)). In the case of a married individual who files a separate return, the limit is $62,500. These limits were scheduled to increase to $150,000 and $75,000, respectively, for taxable years beginning after 1984.

Reasons for Change

Congress believed that delaying a relatively small increase in the amount of used property eligible for the investment credit will have no important effect on overall investment in the economy, but will contribute to reducing budget deficits.

Explanation of Provision

The Act holds the maximum amount of used property eligible for the investment credit at its current level of $125,000 per year until taxable years beginning after 1987, when this limit is increased to $150,000.

Effective Date

The provision is effective with respect to taxable years ending after 1983.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $44 million in 1985, $104 million in 1986, $112 million in 1987, and $65 million in 1988.

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[1] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 12; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), p. 1112; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 12; S. Prt. 98-169, Vol. I (April 2, 1984), p. 106; and H. Rep. No. 98-861 (June 23, 1984), p. 772 (Conference Report).

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2. Finance Leasing (sec. 12 of the Act, sec. 168 of the Code, and sec. 209(d) of the Tax Equity and Fiscal Responsibility Act of 1982)[2]

Prior Law

Overview

The law contains rules (pre-safe harbor lease rules) to determine who owns an item of property for tax purposes when the property is subject to an agreement which the parties characterize as a lease. Such rules are important because the owner of the property is entitled to claim tax benefits including cost recovery deductions and investment tax credits with respect to the property. The pre-safe harbor rules attempt to distinguish between true leases, in which the lessor owns the property for tax purposes, and conditional sales or financing arrangements, in which the user of the property owns the property for tax purposes. These rules generally are not written in the Internal Revenue Code. Instead they evolved over the years through a series of court cases and revenue rulings and revenue procedures issued by the Internal Revenue Service. Essentially, the law is that the economic substance of a transaction, not its form, determines who is the owner of property for tax purposes. Thus, if a transaction is, in substance, simply a financing arrangement, it is treated that way for tax purposes, regardless of how the parties choose to characterize it. Under the pre-safe harbor lease rules, lease transactions cannot be used solely for the purpose of transferring tax benefits. They have to have nontax economic substance.

The Economic Recovery Tax Act of 1981 (ERTA) provided a new set of rules which represented a major departure from the pre-safe harbor rules. These provisions were intended to be a means of transferring tax benefits rather than a means of determining which person is in substance the owner of the property. Under these rules (safe-harbor lease rules), certain transactions involving tangible personal property were treated as leases for Federal income tax purposes regardless of their nontax economic substance. The pre-safe harbor leasing rules continued to apply for transactions not qualifying under the safe-harbor lease rules or when the safe harbor was not elected.

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) generally repealed safe-harbor leasing. In its place, TEFRA substituted a liberalized form of pre-safe harbor leasing called finance

[2] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 13; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1113-1119; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 13; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 107-110; and H. Rep. No. 98-861 (June 23, 1984), pp. 766-772 (Conference Report).

leasing. The finance lease rules essentially provide that certain parts of the pre-safe harbor rules are not taken into account in determining whether an agreement with respect to a limited class of property is a lease for tax purposes. Thus, the pre-safe harbor rules apply when finance lease rules are unavailable, and, except to the extent not taken into account under the finance lease rules, they apply when the finance lease rules are available.

Pre-safe harbor leasing rules

Underlying principles

In general, the determination of lease treatment under the pre-safe harbor leasing rules requires a case-by-case analysis based on all the facts and circumstances. Although the determination of whether a transaction is a lease is inherently factual, a series of general principles is embodied in court cases, revenue rulings, and revenue procedures. These principles are used in determining the character of transactions not eligible for the safe-harbor lease rules.

For a transaction to be a lease under these rules, the lessee generally cannot hold title to or have a significant equity interest in the property. However, the fact that the lessor has title does not guarantee that the lessor is the owner for Federal income tax purposes. Both the courts and the IRS look to additional criteria in determining whether a transaction is a lease. These criteria focus on the substance of the transaction rather than its form. The courts do not disregard the form of a transaction simply because tax considerations are a significant motive so long as the transaction also has a bona fide business purpose and the lessor retains sufficient burdens and benefits of ownership.[3]

To be entitled to depreciation deductions as the owner of the property, the lessor has to show that the property is being used by it for a business or other income-producing purpose. To have a business purpose, the person claiming ownership (i.e., the lessor) at least has to have a reasonable expectation that he will derive a profit from the transaction independent of tax benefits.[4] This requirement precludes lease treatment for a transaction intended merely to reduce the user's costs by utilizing the lessor's tax base. For a sale-leaseback, other nontax business motives have been considered in determining the substance of the transaction.

The fact that the lessor in a lease financing transaction can show a profit or business purpose, however, does not automatically result in lease treatment under pre-safe harbor lease rules, since a profit or business motive could also exist in a financing arrangement. In addition, the lessor has to retain meaningful benefits and burdens of ownership.[5] Thus, lease treatment has been denied under pre-safe harbor lease rules if the user has the option to acquire the property at the end of the lease for a price that either is nominal

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[3] See, *Hilton* v. *Commissioner*, 74 T.C. 305 (1980), *aff'd*, 671 F.2d 316 (9th Cir. 1982); *Frank Lyon Co.* v. *United States*, 435 U.S. 561 (1978), *rev'g*, 536 F. 2d 746 (8th Cir. 1976); and Rev. Rul. 55-540, 1955-2 C.B. 39 (and cases cited therein); See generally, *Gregory* v. *Helvering*, 293 U.S. 465 (1935).

[4] See, *Hilton* v. *Commissioner*, 74 T.C. 305 (1980), *aff'd*, 671 F. 2d 316 (9th Cir. 1982).

[5] See, *Frank Lyon Co.* v. *United States*, 435 U.S. 561 (1978), *rev'g*, 536 F.2d 746 (8th Cir. 1976); and Rev. Rul. 55-540, 1955-2 C.B. 39 (and cases cited therein).

in relation to the value of the property at the time when the option can be exercised (as determined at the time the parties entered into the agreement) or which is relatively small when compared with the total payments required to be made.[6]

Where the residual value of the property to the lessor is nominal, the lessor has been viewed as having transferred full ownership of the property for the rental fee. Where the purchase option is more than nominal but relatively small in comparison with fair market value, the lessor may still be viewed as having transferred full ownership if the likelihood that the lessee will exercise the bargain purchase option is great.[7] Furthermore, if the lessor can force the lessee to purchase the property at the end of the lease (a put), the transaction might also be denied lease treatment under pre-safe harbor lease rules if the put eliminates the risk borne by owners of property that there may be no market for the property at the end of the lease.

Objective guidelines used in structuring transactions

The question of exactly what burdens and benefits of ownership have to be retained by the lessor under pre-safe harbor lease rules created some confusion and difficulty for people trying to structure leases that, at least in part, were motivated by tax considerations. To give taxpayers guidance in structuring leveraged leases (i.e., where the property is financed by a loan from a third party), the Internal Revenue Service in 1975 issued Revenue Procedure 75-21, 1975-1 C.B. 715, and a companion document, Revenue Procedure 75-28, 1975-1 C.B. 752 (the guidelines). If the requirements of the guidelines are met and if the facts and circumstances do not indicate a contrary result, the Service will issue an advance letter ruling that the transaction is a lease and that the lessor is the owner for Federal income tax purposes.

The guidelines generally apply only to leveraged leases of equipment. The general principles described above continue to govern nonleveraged leases and leases of real property. The guidelines are not a definitive statement of legal principles and are not intended for audit purposes. If less than all requirements of the guidelines are met, a transaction might still be considered a lease if, under all the facts and circumstances, the transaction is a lease under the general principles discussed previously. However, in practice, many taxpayers have taken into account the guidelines' requirements in structuring transactions. The guidelines may be viewed as a type of safe harbor.

The specific requirements for obtaining a ruling under the guidelines are as follows:

(1) *Minimum investment.*—The lessor must have a minimum 20 percent unconditional at-risk investment in the property. This rule represents an attempt to ensure that the lessor experiences some significant loss if the property declines in value. By limiting the degree of nonrecourse leverage, this guideline also limits the pool of potentially transferable tax benefits from such transactions.

(2) *Purchase options.*—In general, the lessee may not have an option to purchase the property at the end of the lease term unless,

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[6] See, Rev. Rul. 55-540, 1955-2 C.B. 39 (and cases cited therein).

[7] See, *M&W Gear Co.* v. *Commissioner*, 446 F.2d 841 (7th Cir. 1971).

under the lease agreement, the option can be exercised only at fair market value (determined at the time of exercise). This rule precludes fixed price purchase options, even at a bona fide estimate of the projected fair market value of the property at the option date. In addition, when the property is first placed in service by the lessee, the lessor cannot have a contractual right to require the lessee or any other party to purchase the property, even at fair market value.

The fair market value purchase option requirement fulfills three purposes related to the determination of the economic substance of the transaction. First, it ensures that the lessor bears the risk implicit in ownership that no market or an unfavorable market will exist at the end of the lease. Second, it ensures that the lessor has retained an equity interest in the property. Any fixed price option represents a limitation on the lessor's right of full enjoyment of the property's value. Third, it limits the ability of the parties to establish an artificial rent structure to avoid the cash flow test (described below). However, several courts have held that the mere existence of a fixed price purchase option does not prevent lease treatment so long as the lessor retains other significant burdens and benefits of ownership.[8]

(3) *Lessee investment precluded.*—Neither the lessee nor a party related to the lessee may furnish any part of the cost of the property. The rationale is that a lessee investment may suggest that the lessee is in substance a co-owner of the property.

(4) *No lessee loans or guarantees.*—As a corollary to the prior rule, the lessee must not loan to the lessor any of the funds necessary to acquire the property. In addition, the lessee must not guarantee any lessor loan.

(5) *Profit and cash flow requirements.*—The lessor must expect to receive a profit from the transaction and have a positive cash flow from the transaction independent of tax benefits. These guidelines are based on the requirement, as previously mentioned, that lease transactions must have a business purpose independent of tax benefits.

(6) *Limited use property.*—Under Revenue Procedure 76-30, 1976-2 C.B. 647, property that can be used only by the lessee (limited use property) is not eligible for lease treatment. The rationale is that if the lessee is the only person who could realistically use the property, the lessor has not retained any significant ownership interest.

Safe-harbor leasing rules

The safe-harbor leasing provisions of ERTA were intended to permit owners of property who were unable to use depreciation deductions and investment credits to transfer those benefits to persons who were able to use them, without having to meet the presafe harbor lease requirements for characterizing the transaction as a lease. The safe-harbor leasing provisions operated by guaranteeing that, for Federal income tax purposes, qualifying transactions were treated as leases and that the nominal lessor was treated as the owner of the property, even though the lessee was in sub-

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[8] See, e.g., *Northwest Acceptance Corp.* v. *Commissioner*, 58 T.C. 836 (1972), *aff'd*, 500 F.2d 1222 (9th Cir. 1974).

stance the owner of the property and the transaction otherwise would not have been considered a lease.[9]

The Tax Equity and Fiscal Responsibility Act of 1982 generally repealed safe-harbor leasing.

Finance lease provisions

TEFRA provided rules (finance leasing rules) which in two respects liberalized the pre-safe harbor leasing rules with respect to certain property. Under the finance leasing rules, the fact that (1) the lessee has an option to purchase the property at a fixed price of 10 percent or more of its original cost to the lessor or (2) the property is limited use property is not taken into account in determining whether the agreement is a lease.

A qualified agreement must be a lease determined without taking into account the fact that it contains a 10-percent fixed price purchase option or that the property is limited use property. Thus, the transaction must have economic substance independent of tax benefits. The lessor must reasonably expect to derive a profit independent of tax benefits. In addition, the transaction, without taking into account the fact the agreement contains a fixed price purchase option or that the property is limited use property, must not otherwise be considered a financing arrangement or conditional sale.

The finance lease rules were to have been generally effective for agreements entered into after December 31, 1983, with three temporary restrictions intended to limit the tax benefits of finance leasing in 1984 and 1985. First, no more than 40 percent of property placed in service by a lessee during any calendar year beginning before 1986 can qualify for finance lease treatment. Second, a lessor cannot use finance lease rules to reduce its tax liability for any taxable year by more than 50 percent. This 50-percent lessor cap applies to property placed in service on or before September 30, 1985. Third, the investment tax credit for property subject to a finance lease and placed in service on or before September 30, 1985, is only allowable ratably over 5 years, rather than entirely in the year the property is placed in service.

Notwithstanding these general rules, finance leasing is available for up to $150,000 per calendar year of a lessee's farm property for agreements entered into after July 1, 1982, and before 1984. Furthermore, the 40-percent lessee cap, 50-percent lessor cap, and 5-year spread of the investment credit do not apply to this amount of farm property.

Reasons for Change

Prior law would have permitted lease treatment, beginning in 1984, for agreements which would be appropriately treated as leases under current administrative rules and practices were it not for the fact that the agreements contained a fixed price purchase option or pertained to limited use property. The Act postpones these relaxations of current administrative guidelines until 1988,

[9] For a discussion of the safe-harbor lease eligibility requirements, see the General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982, prepared by the Staff of the Joint Committee on Taxation (December 31, 1982).

and in so enacting Congress intended that the guidelines should not be relaxed by administrative action.

The Act does not include a provision to prohibit the Treasury from issuing leasing regulations before 1988. Congress reached this decision on the basis of an understanding that the Treasury does not intend to liberalize significantly the current administrative rules and practices for determining whether an agreement is a lease or a financing arrangement. Congress also took into account the fact that a prohibition could have precluded perfecting modifications which may be shown to be necessary but which would not operate to liberalize current administrative guidelines in this area.

Congress was concerned that agreements represented as leases were being used to transfer the tax benefits of ownership from persons who could not utilize them to nominal lessors who could, when in substance the nominal lessor did not have a significant at-risk investment in the property itself. Current administrative rules and procedures were designed to check such tax benefit transfers. Therefore, the primary objective of Congress was that there be no relaxation of administrative rules and practices that would result in lease treatment for financing transactions in which the purported lessor does not have a significant ownership interest in the property. While recognizing that in some cases special factors may need to be taken into account, Congress believed that current administrative rules and practices, when applied to the broad range of conventional lease financing transactions, produce a satisfactory and appropriate differentiation between leases and financing arrangements.

Explanation of Provision

The Act postpones the effective dates of the finance lease rules for four years. Thus, finance leasing first becomes generally effective for agreements entered into after December 31, 1987, and the three restrictions previously scheduled to apply only in 1984 and 1985 are extended into 1989. First, the 40-percent lessee cap is extended to cover property placed in service by a lessee during any calendar year beginning before 1990. Second, the 50-percent lessor cap is extended through September 30, 1989. Third, the 5-year spread of the investment credit for property subject to a finance lease is extended to cover property placed in service on or before September 30, 1989. Special rules relating to the availability of finance leasing for up to $150,000 per calendar year of a lessee's farm property are extended to cover agreements entered into before 1988.

The Act provides transitional rules which exempt property from the 4-year postponement if, before March 7, 1984, (1) a binding contract to acquire or construct the property was entered into by or for the lessee, (2) the property was acquired by the lessee, or (3) construction of the property was begun by or for the lessee. In addition, the Act exempts from the 4-year postponement property which is placed in service before 1988 and is (1) a qualified lessee's automotive manufacturing property (limited to an aggregate of $150 million of cost basis per lessee) or (2) property that is part of a coal-fired cogeneration facility for which certification and construction permit applications were filed on specified dates.

Effective Date

The provision is effective with respect to taxable years ending after 1983.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $63 million in 1984, $348 million in 1985, $862 million in 1986, $1,381 million in 1987, $1,424 million in 1988, and $741 million in 1989.

3. Expensing of Business Personal Property (sec. 13 of the Act and sec. 179 of the Code)[10]

Prior Law

A taxpayer (other than a trust or estate) may elect, in lieu of capital cost recovery under the Accelerated Cost Recovery System (ACRS), to deduct the cost of qualifying property in the taxable year it is placed in service (sec. 179). In general, qualifying property must be acquired by purchase for use in a trade or business and must otherwise be eligible for the investment tax credit. No investment credit is allowable for the portion of the cost of property expensed under this rule.

For taxable years beginning in 1983, the limit on the amount that can be expensed is $5,000 a year. This limit was scheduled to increase to $7,500 for taxable years beginning in 1984 and 1985, and to $10,000 for taxable years beginning after 1985. In the case of a married individual who files a separate return, the limit is reduced by 50 percent.

Reasons for Change

Congress believed that a freeze of the limitation on expensing would contribute to deficit reduction without having adverse economic effects. For the type of property that is eligible for expensing, the benefits to the taxpayer of claiming the investment credit and recovering costs under ACRS are generally no less in present value than actual expensing.

Explanation of Provision

The Act postpones for four years the scheduled increases in the maximum amount of property that can be expensed. Thus, the limit on the amount that can be expensed remains at $5,000 for taxable years beginning before 1988, increases to $7,500 for taxable years beginning in 1988 and 1989, and increases to $10,000 for taxable years beginning after 1989.

Effective Date

The provision is effective with respect to taxable years ending after 1983.

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[10] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 14; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1119-1120; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 14; S. Prt. 98-169, Vol. 1 (April 2, 1984), p. 111; and H. Rep. No. 98-861 (June 23, 1984), pp. 772-773 (Conference Report).

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $230 million in 1984, $399 million in 1985, $433 million in 1986, and $386 million in 1987, and to decrease fiscal year budget receipts by $118 million in 1988 and $427 million in 1989.

4. Employee Stock Ownership Credit (sec. 14 of the Act and sec. 41 of the Code)[11]

Prior Law

An employee stock ownership plan (ESOP) is a tax-qualified plan under which employer stock is held for the benefit of employees. An ESOP under which an employer contributes stock or cash in order to qualify for a credit against income tax liability is referred to as a tax credit ESOP.

An electing employer is permitted to take an income tax credit for contributions to a tax credit ESOP, which is limited to a prescribed percentage of the aggregate compensation of all employees under the plan. For compensation paid or accrued in calendar years 1983 and 1984, the tax credit is limited to one-half of one percent. Under prior law, with respect to compensation paid or accrued in 1985, 1986, and 1987, the limit was three-quarters of one percent. No credit is provided with respect to compensation paid or accrued after December 31, 1987.

Reasons for Change

The Congress believed that, in light of the current budget situation, it is appropriate to repeal the scheduled increase in the maximum tax credit for employer contributions to tax credit ESOPs.

Explanation of Provision

Under the Act, the scheduled increase in the tax credit is repealed. Thus, the income tax credit for contributions to a tax credit ESOP applicable to compensation paid or accrued in calendar years 1985, 1986, and 1987 is limited to one-half of one percent. As under prior law, no credit is provided with respect to compensation paid or accrued after December 31, 1987.

Effective Date

The provision became effective July 18, 1984.

Revenue Effect

It is estimated that the ESOP provisions of the Act (including secs. 541–545) will increase fiscal year budget receipts by $322 million in 1985, $593 million in 1986, $757 million in 1987, $495 million in 1988, and $274 million in 1989.

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[11] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 15; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1120-21; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 15; S. Prt. 98-169, Vol I (April 2, 1984), pp. 331-36; and H. Rep. No. 98-861 (June 23, 1984), pp. 1181-84 (Conference Report).

5. Limits on Contributions and Benefits under Qualified Plans (sec. 15 of the Act and sec. 415 (d) of the Code)[12]

Prior Law

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) reduced the overall limits on contributions and benefits under qualified pension, profit-sharing, and stock bonus plans ("qualified plans"), tax-sheltered annuity programs, and simplified employee pensions (SEPs). The dollar limit on the annual addition under a defined contribution plan is $30,000, and the dollar limit on the annual benefit payable under a defined benefit plan is $90,000.

TEFRA suspended all cost-of-living adjustments to these dollar limits until 1986. Beginning in 1986, the limits were to be adjusted for post-1984 cost-of-living increases under the formula then in effect to provide cost-of-living increases in social security benefits.

Reasons for Change

The Congress believed that it was appropriate to delay further the cost-of-living adjustments to the dollar limits on contributions and benefits under qualified plans, tax-sheltered annuity programs, and SEPs.

Explanation of Provision

Under the provision, the cost-of-living increases to the dollar limits on contributions and benefits under qualified plans, tax-sheltered annuity programs, and SEPs is postponed until 1988. Beginning in 1988, the limits are adjusted for post-1986 cost-of-living increases under the formula then in effect to provide cost-of-living increases in social security benefits.

Effective Date

The provision became effective on July 18, 1984.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $17 million in 1986, $64 million in 1987, $106 million in 1988, and $115 million in 1989.

[12] For legislative background of the provision, see: committee amendment to H.R. 4170, approved by the House Committee on Ways and Means on March 1, 1984, sec. 16; H. Rep. No. 98-432, Part 2 (March 5, 1984), p. 1121; "Deficit Reduction Act of 1984," as reported by the Senate Committee on Finance on March 21, 1984, sec. 85; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 298-300; H. Rep. 98-861 (June 23, 1984, p. 1146 (Conference Report).

6. Repeal of Net Interest Exclusion (sec. 16 of the Act and sec. 128 of the Code)[13]

Prior Law

Background

In the Economic Recovery Tax Act of 1981 (ERTA),[14] Congress repealed the $200 ($400 on a joint return) interest and dividend exclusion for taxable years beginning after 1981.[15] Congress also established a temporary program of tax-exempt certificates (generally known as All-Savers Certificates). All-Savers Certificates were issuable by qualified savings institutions from September 30, 1981, through December 31, 1982. A lifetime exclusion from gross income of $1,000 ($2,000 in the case of a joint return) of interest earned on qualified tax-exempt certificates was provided.

ERTA also liberalized the requirements governing eligibility for, and deductibility of, contributions to individual retirement accounts (IRAs).[16]

Net interest exclusion

For taxable years beginning after 1984 (i.e., one year after the expiration of the All-Savers Certificate program), ERTA provided for an exclusion of 15 percent of net interest received up to $3,000 of net interest ($6,000 on a joint return).

Net interest was generally defined as eligible interest received by the taxpayer in excess of the amount of interest payments by the taxpayer for which an income tax deduction was allowed. Payments of mortgage interest and trade or business interest were not taken into account to reduce eligible interest.

Reasons for Change

The net interest exclusion was enacted in 1981 as part of a series of tax incentives to encourage savings. The net interest exclusion was intended to be a permanent savings incentive to replace the temporary All-Savers Certificate program for taxable years beginning after 1984. However, the 1981 ERTA liberalization of the IRA tax rules has resulted in more savings being invested in IRAs. As a result, revenue losses from the IRA program have been significant-

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[13] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 17; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1122-23; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 17; S. Prt. No. 98-169, Vol. I (April 2, 1984), pp. 113-14; and H. Rep. No. 98-861 (June 23, 1984), p. 773 (Conference Report).

[14] P.L. No. 97-34.

[15] For subsequent years, the $100 dividend exclusion previously in effect was reinstated and amended to permit an exclusion of up to $200 to be claimed on a joint return without regard to which spouse actually receives the dividend.

[16] See ERTA, section 311; H. Rep. No. 97-201, 97th Cong., 1st Sess. 132-37 (1981); S. Rep. No. 97-144, 97th Cong., 1st Sess. 111-15 (1981).

ly larger than was originally projected. In light of these unexpectedly large revenue losses and expected deficits, Congress believed that it would be inappropriate to allow the net interest exclusion to take effect.

A further problem with the net interest exclusion is that, because it only applies to interest income, it might distort savings incentives away from equity investment and towards debt. In view of the existing incentives for debt finance that result from the deductibility of interest, Congress believed that such a further skewing of investment incentives would be undesirable.

Accordingly, Congress decided that the net interest exclusion scheduled to take effect in 1985 should be repealed.

Explanation of Provision

The Act repeals the net interest exclusion enacted in ERTA for taxable years beginning after 1984.

Effective Date

This provision became effective on the date of enactment (July 18, 1984).

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $1,024 million in 1985, $2,858 million in 1986, $3,100 million in 1987, $3,366 million in 1988, and $3,637 million in 1989.

7. Postponement of Increase in Foreign Earned Income Exclusion (sec. 17 of the Act and sec. 911 of the Code)[17]

Prior Law

Certain U.S. citizens and resident aliens living abroad are allowed to exclude or deduct certain foreign housing expenses. In 1983, certain U.S. citizens and resident aliens who lived abroad also were allowed to exclude from taxable income up to $80,000 of foreign earned income. Under the Economic Recovery Tax Act of 1981, this amount was scheduled to increase to $85,000 in 1984, to $90,000 in 1985, and to $95,000 in 1986 and thereafter. If the taxpayer claims the exclusion, he or she cannot claim a foreign tax credit with respect to U.S. tax on excluded amounts.

Reasons for Change

The Congress believed that Americans working abroad help promote the export of U.S. manufactured goods and services. Consequently, the Congress wished to retain an exclusion from taxable income for a substantial amount of foreign earned income. However, the Congress believed that delaying increases in the amount of the foreign earned income exclusion would have no important effect on U.S. exports, but would make a contribution in reducing Federal budget deficits. Reducing budget deficits should improve the United States' balance of trade.

Explanation of Provision

The Act retains the maximum foreign earned income exclusion at its 1983 level of $80,000 per year until taxable years beginning in 1988, when this limit will increase to $85,000. The limit will increase to $90,000 in taxable years beginning in 1989 and to $95,000 in taxable years beginning in 1990 and thereafter.

Effective Date

The provision became effective on the date of enactment (July 18, 1984), and reduces the excludable amount to $80,000 for the entire calendar year 1984.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $4 million in 1984, $31 million in 1985, $80 million in 1986, $106 million in 1987, $107 million in 1988, and $79 million in 1989.

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[17] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 18; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), p. 1123-24; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 18; S. Rep. No. 98-169. Vol. I (April 2, 1984), p. 115; and H. Rep. No. 98-861 (June 23, 1984), pp. 773-74 (Conference Report).

8. Defer Scheduled Reductions in Maximum Gift and Estate Tax Rates (sec. 21 of the Act and secs. 2001 and 2502 of the Code)[18]

Prior Law

The Economic Recovery Tax Act of 1981 (ERTA)[19] enacted reductions in the maximum gift and estate tax rates, to take effect over a four year period. The maximum rate before ERTA was 70 percent. ERTA reduced the maximum rates to 60 percent for gifts made and individuals dying in 1983; 55 percent in 1984; and 50 percent thereafter (Code secs. 2001 and 2502).

Reasons for Change

The scheduled reductions in the maximum Federal gift and estate tax rates were enacted in 1981 as part of a broad-based tax reduction measure. Since that time, budgetary constraints have necessitated increased revenues. Congress believed that it was inappropriate to continue these scheduled reductions at a time when revenue increases generally were being enacted.

Explanation of Provision

Under the Act, the maximum gift and estate tax rates is 55 percent for gifts made and individuals dying in 1984 through 1987. The rate will be reduced to 50 percent beginning in 1988.

Effective Date

This provision is effective for gifts made, and for estates of individuals dying, after December 31, 1983.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by less than $5 million in 1985, $251 million in 1986, $332 million in 1987, $381 million in 1988, and by less than $5 million in 1989.

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[18] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 21; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), p. 1124; and H. Rep. No. 98-861 (June 23, 1984), p. 774 (Conference Report).

[19] P. L. 97-34.

9. Windfall Profit Tax on Newly Discovered Oil (sec. 25(a) of the Act and sec. 4987(b)(3) of the Code)[20]

Prior Law

Present and prior law imposes an excise tax on the production of domestic crude oil. Differing tax rates and base prices apply to taxable oil, generally depending upon its classification on one of three tiers.

Tier 1 oil (previously controlled oil) generally is taxed at a 70-percent rate; tier 2 oil generally is taxed at a 60-percent rate. A 50-percent rate applies to up to 1,000 barrels a day of tier 1 oil production by independent producers. In the case of tier 2 oil (stripper oil), production by independent producers generally is exempt from tax.

Tier 3 oil is newly discovered oil, heavy oil, and incremental tertiary oil. Prior to 1982, all tier 3 oil was subject to tax at a 30-percent rate. Starting in 1982, the rate on newly discovered oil was reduced to 27-1/2 percent and to 25 percent in 1983. Under prior law, the rate of windfall profit tax on newly discovered oil was 22-1/2 percent for 1984, 20 percent for 1985, and 15 percent for 1986 and later years. During the fourth quarter of 1984, the windfall profit tax on a typical barrel of newly discovered oil would be approximately $.80 at the 22-1/2 percent rate.

Reasons for Change

Congress believed that the rate of tax on newly discovered oil should be frozen at its 1984 level in connection with its general freeze on other tax reductions.

Explanation of Provision

Under the Act, the rate of windfall profit tax on newly discovered oil remains at the 1984 level of 22-1/2 percent through 1987 and is then reduced to 20 percent for 1988, and to 15 percent for 1989 and later years.

Effective Date

This provision applies with respect to domestic crude oil removed from the premises on which it was produced after December 31, 1983.

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[20] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 25; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1124-1125; and H. Rep. No. 98-861 (June 23, 1984), pp. 774-775 (Conference Report).

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Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $5 million in 1985 only.

10. Percentage Depletion for Secondary and Tertiary Production after 1983 (sec. 25(b) of the Act and sec. 613(c) of the Code)[21]

Prior Law

In the Tax Reduction Act of 1975, Congress retained the percentage depletion allowance for limited quantities of oil and gas production. For oil production, effective January 1, 1984, the rate has declined to a permanent level of 15 percent and is limited to 1,000 barrels per day.

The 1975 amendment continued this percentage depletion allowance for secondary and tertiary production at a 22-percent rate but, because of a technical error, only through 1983. Also under prior law, a special rule reduced the depletable oil amount by any secondary or tertiary production. Therefore, a producer's depletable quantity of primary production would have been reduced by any secondary or tertiary production even though percentage depletion was not available for such production.

Under the 1975 amendments, if an interest in any proven oil or gas property is transferred to another owner after 1974, no percentage depletion allowance applied to the property after the transfer unless one of the exceptions provided for in section 613A(c)(9) or (10) applies. Proposed proposed Treasury regulations, published in 1977, stated that the transfer restrictions would not apply to percentage depletion for secondary and tertiary production. This exception to the transfer rule resulted from the same 1975 statutory drafting error that caused termination of such percentage depletion after 1983.

Reasons for Change

Congress wished to correct the technical errors made in the Tax Reform Act of 1975.

Explanation of Provision

The Act corrects the technical errors which occurred in the Tax Reform Act of 1975 with respect to depletion on secondary and tertiary depletion. Thus, the Act eliminates the distinction between primary and secondary or tertiary production after 1983. Independent producers may, therefore, claim percentage depletion in 1984 at a rate of 15 percent on up to 1,000 barrels of all their production. In addition, starting in 1984, percentage depletion on secondary and tertiary production is not available for production from proven

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[21] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 25; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1125-1126; and H. Rep. No. 98-861 (June 23, 1984), pp. 775-776 (Conference Report).

properties transferred since 1974 unless one of the exceptions provided for in sections 613A(c)(9) and (10) applies to the transfer.

Effective Date

This provision was effective on January 1, 1984.

Revenue Effect

Because the results achieved by this provision were originally intended to be achieved under the 1975 amendments, the provision has no effect on revenues.

11. Extension of Telephone Excise Tax (sec. 26 of the Act and sec. 4251 of the Code)[22]

Prior Law

A three-percent excise tax is imposed on amounts paid for local telephone service, toll telephone service, and teletypewriter exchange service (Code sec. 4251). The tax is paid by the person who pays for service to the person rendering the service, who in turn remits the tax to the Federal Government.

Exemptions from the tax are provided for communications services furnished to news services (except local telephone service to news services), international organizations, the American National Red Cross, servicemen in combat zones, nonprofit hospitals and educational organizations, and State and local governments. Other exemptions are provided for amounts paid for installation charges and for certain calls from coin-operated telephones (sec. 4253).

Under prior law, this excise tax was scheduled to terminate, effective with respect to amounts paid pursuant to bills first rendered after December 31, 1985.

Reasons for Change

Congress determined that continuation of the telephone excise tax was appropriate due to the existing budgetary deficit situation. Congress did not believe it appropriate to permit existing taxes to be reduced or expire at a time when it was increasing taxes generally.

Explanation of Provision

The Act extends the telephone excise tax at a three-percent rate for two years, through December 31, 1987.

Effective Date

This provision became effective on the date of enactment (July 18, 1984).

Revenue Effect

This provision is estimated to increase net fiscal year budget receipts by $1,168 million in 1986, $2,016 million in 1987, and $803 million in 1988.

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[22] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 26; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), p. 1129; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 16; S. Prt. 98-169, Vol. I (April 12, 1984), p. 112; and H. Rep. No. 98-861 (June 23, 1984), p. 778 (Conference Report).

12. Increase in the Distilled Spirits Excise Tax Rate (sec. 27 of the Act and secs. 5001, 5010, and 5013 of the Code)[23]

Prior Law

An excise tax is imposed on distilled spirits produced in or imported into the United States (Code sec. 5001). The tax is determined when the distilled spirits are removed from a bonded distillery or released from customs custody.

Under prior law, the rate of tax on distilled spirits was $10.50 per proof gallon. A proof gallon of distilled spirits is defined as a U.S. gallon of liquid one-half of the volume of which consists of ethyl alcohol of a specified gravity (sec. 5002).

Reasons for Change

Before consideration of the Act, Congress had not increased the tax on distilled spirits since 1951. Because the tax is imposed as a flat amount, rather than as a percentage of sales price, the effective level of the tax had declined by more than 70 percent in constant dollars since that increase. Congress believed, therefore, that a modest adjustment of $2.00, to $12.50 per proof gallon, was appropriate. Increasing the tax rate by this amount does not increase the per-proof-gallon rate, in real terms, above the 1951 level.

Explanation of Provisions

Tax rate

The Act increases the distilled spirits tax rate by $2.00 per proof gallon, effective on October 1, 1985.

Floor stocks tax

In general

The Act also imposes a special tax extending the increased tax rate to certain floor stocks. Under the Act, a special tax of $2.00 per proof gallon generally is imposed on distilled spirits held for sale on October 1, 1985, which distilled spirits were removed from bonded premises before that date, and a tax at the pre-October 1, 1985, rate was imposed at the time of such removal. The term held for sale does not include merchandise withdrawn from, or in the process of withdrawal from, the market. The special tax is treated as if it were a tax imposed under Code section 5001. The floor stocks tax generally will be due on April 1, 1986.

[23] For legislative background of the provision see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 27; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), p. 1126; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 822; S. Prt. 98-169, Vol. I (April 2, 1984), p. 756; and H. Rep. No. 98-861 (June 23, 1984), p. 776 (Conference Report).

Certain special *de minimis* provisions are included for small -and middle-sized wholesale and retail dealers. The *de minimis* exceptions provide the following:

Exemption from tax

All persons holding distilled spirits for sale on October 1, 1985, are required to conduct a liquid volume (e.g., wine gallon) inventory. Dealers whose wine gallon inventory volume is less than 500 gallons are exempt from the floor stocks tax. Dealers with an inventory of 500 liquid gallons or more are required to conduct a proof gallon inventory and to pay floor stocks tax on that inventory, but these dealers will receive a credit against the tax equal to $800 (the approximate tax on 500 wine gallons).

Extension of time for payment of tax

Dealers whose gross sales receipts from all products in the preceding taxable year did not exceed $500,000 are allowed to pay the floor stocks tax in three installments, one-third on each of April 1, 1986, July 1, 1986, and October 1, 1986.

Effective Date

These provisions are effective on October 1, 1985.

Revenue Effect

These provisions are estimated to increase net fiscal year budget receipts by $149 million in 1985, $311 million in 1986, $510 million in 1987, $520 million in 1988, and $535 million in 1989.

13. Requirement of Electronic Funds Transfer for Alcohol and Tobacco Excise Taxes (sec. 27 of the Act and secs. 5061 and 5703 of the Code)[24]

Prior Law

Payment of the Federal excise taxes on alcohol and tobacco products is required upon removal of the products from bonded premises (including customs custody). If a bond is posted with the Treasury Department, payment of tax may be deferred until the due date of the applicable tax return.

Returns of alcohol and tobacco excise taxes are required to be made on a semimonthly basis. The returns are due a specified number of days after the conclusion of the relevant semimonthly period (30 days for domestically produced distilled spirits, 15 days for beer and wine, and 25 days for most tobacco products). Importers of alcohol and tobacco products are required to pay the excise taxes on those products no later than 15 days after their removal from customs custody.

Regulations proposed by the Treasury Department in January 1981 would have required payment of alcohol and tobacco taxes by electronic funds transfer in the case of taxpayers who paid $5 million or more in those taxes in the previous fiscal year. These regulations never became effective because of restrictions included in prior continuing appropriations Acts for the Treasury Department.

Reasons for Change

Electronic transfer of funds is an established practice in many segments of the economy and has proven to be an accurate and efficient method of transferring large sums of money. Congress believed that requiring electronic transfers of excise tax payments for alcohol and tobacco products is more efficient than the prior system where taxpayers attached a check to a return which was then mailed to the Treasury Department. However, to prevent any undue burden on taxpayers liable for small amounts of tax, Congress decided to require payment by electronic funds transfer only by taxpayers who were liable for a gross amount equal to or exceeding $5 million of the applicable tax during the preceding calendar year.

Explanation of Provisions

The Act requires persons who were liable for $5 million or more in any alcohol or tobacco excise tax during the preceding calendar

[24] For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 847; S. Prt. 98-169, Vol. I (April 2, 1984), p. 806; and H. Rep. No. 98-861 (June 23, 1984) p. 777 (Conference Report).

year to pay that tax by electronic funds transfer to the Treasury Department account at a Federal Reserve Bank on each semimonthly due date during the succeeding calendar year. This requirement applies regardless of the amount of such excise tax for which the person is liable during the succeeding year. Congress intended that the Treasury Department may identify a specific Federal Reserve Bank and any specific method of electronic funds transfer by use of which this requirement is to be satisfied. The requirement of payment by electronic funds transfer applies both to domestic producers and manufacturers (including Puerto Rican and Virgin Islands producers and manufacturers) and to importers of taxable alcohol and tobacco products.

The determination of whether a person was liable for $5 million or more in alcohol or tobacco tax in any calendar year is made by reference to the person's gross tax liability (without regard to any drawbacks or refunds). The term person includes all members of a controlled group of corporations (sec. 1563); likewise all locations at which a person carries on business are to be aggregated. Additionally, this determination is made by treating all types of distilled spirits as one product. Similarly, all types of beer are treated as one product, and all types of wines are treated as one product. In the case of tobacco, the determination is made by reference to all types of taxable tobacco products (e.g., a person liable for tax with respect to cigarettes, cigarette papers, and cigars is treated as liable for tax with respect to one product).

Effective Date

This provision applies to taxes required to be paid on or after September 30, 1984.

Revenue Effect

This provision is estimated to increase net fiscal year budget receipts by $341 million in 1985, to decrease receipts by $52 million in 1986, and to increase such receipts by $5 million annually thereafter.

B. Leasing Provisions

1. Tax-Exempt Entity Leasing (sec. 31 of the Act and secs. 46, 48, 168, and 7701 of the Code)[1]

Prior Law

Overview

The rules for determining who is entitled to the tax benefits associated with the ownership of property generally are not written in the Internal Revenue Code. Rather, they are embodied in a series of court cases and revenue rulings and revenue procedures issued by the Internal Revenue Service ("IRS"). These rules focus on the economic substance of a transaction, not its form, for determining who is entitled to the tax benefits of the ownership of property. Thus, in a purported lease or similar arrangement, the person claiming ownership for Federal income tax purposes must show that he has sufficient economic indicia of ownership.

In general, the tax benefits of ownership of tangible property include depreciation or accelerated cost recovery system ("ACRS") deductions and investment tax credits. Generally, ACRS or other depreciation deductions and investment credits are allowed only for property used for a business or other income-producing purpose. The accelerated cost recovery system generally permits taxpayers to depreciate qualifying property on an accelerated basis over relatively short periods. For most property, the ACRS recovery period is shorter than the actual useful life of the property. Investment credits permit taxpayers to reduce their tax liabilities by a percentage of their investment in eligible property. Eligible property includes certain depreciable personal property. Additional investment credits are available for certain energy property and certain improvements to buildings at least 30 years old.

As a general rule, governmental units and tax-exempt organizations were not entitled to depreciation deductions or investment credits for property owned by them. Moreover, no investment credit was allowed for property used (though not owned) by a tax-exempt organization in its exempt function or by a governmental unit (nontaxable use restriction). The nontaxable use restriction did not affect the allowance of ACRS deductions and certain other tax benefits.

Property used by a foreign government or person was not subject to the nontaxable use restriction. If the property was used predomi-

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[1] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, secs. 31 and 32; H.R. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1131-1169; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, secs. 21 and 22; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 116-154; H.R. Rep. No. 98-861 (June 23, 1984), pp. 778-800 (Conference Report); and H. Con. Res. 328, 130 Cong. Rec. S. 8943 (June 29, 1984), H. 7524 (June 29, 1984).

nantly outside the United States, then, in general, ACRS deductions were reduced and no investment credit was allowed.

The traditional reasons for leasing stemmed from tax, accounting, and a variety of business considerations. Tax-exempt organizations and governmental units leased equipment for many of the same reasons as taxable entities. The recent increase in leasing and similar arrangements was due, in part, to budgetary limitations on the purchase of property and, in the case of some State and local governments, limitations on their ability to issue tax-exempt bonds. From a tax perspective, leasing allowed certain tax benefits (such as ACRS deductions) to flow through (in the form of reduced rents) to nontaxable entities that were not eligible for such benefits on their own account. In some cases, a transaction with a nontaxable entity was arranged as a service contract or in some other form (rather than a lease) in order to avoid the nontaxable use restriction on the investment credit.

What follows is a description of the prior-law rules governing the determination of ownership of property for Federal income tax purposes, in the context of leases or similar arrangements, and a description of the nontaxable use restriction on the investment credit. The rules governing ACRS and the investment credit for property used predominantly outside the United States (foreign-use property) are also discussed.

The ownership issue

Overview

The determination of who is the owner of property for Federal income tax purposes required a case-by-case analysis of all facts and circumstances. Although the determination of ownership is inherently factual, a number of general principles were developed in court cases, revenue rulings, and revenue procedures.

In general, both the courts and the IRS focused on the substance of the transaction rather than its form. The courts did not disregard the form of a transaction simply because tax considerations were a significant motive, so long as the transaction also had a bona fide business purpose and the person claiming tax ownership had sufficient burdens and benefits of ownership.

In general, for Federal income tax purposes, the owner of property was required to possess meaningful burdens and benefits of ownership. The lessor had to suffer or benefit from fluctuations in the value of the property. Thus, lease treatment was denied, and the lessee was treated as the owner, if the lessee had the option to obtain title to the property at the end of the lease for a price that was nominal in relation to the value of the property at the time the option was exercisable or which was relatively small when compared with the total lease payments to be made.

Where the lessor's residual value in the property was nominal, the lessor was viewed as having transferred full ownership of the property for the rental payments. Where the purchase option was more than nominal but relatively small in comparison with fair market value, the lessor was viewed as having transferred full ownership because of the likelihood that the lessee would exercise the option. Furthermore, if the lessor had a contractual right to require the lessee to purchase the property at the end of the lease (a put), the transaction could be denied lease treatment because the put eliminated the lessor's risk of loss in value of the residual interest and the risk that there would be no market for the property at the end of the lease.

Objective guidelines used in structuring transactions

To give taxpayers guidance in structuring leveraged leases (i.e., leases in which the property is financed by a nonrecourse loan from a third party) of equipment, the IRS issued Rev. Proc. 75-21, 1975-1 C.B. 715, and a companion document, Rev. Proc. 75-28, 1975-1 C.B. 752 (the guidelines). If the requirements of the guidelines were met and if the facts and circumstances did not indicate a contrary result, the IRS generally issued an advance letter ruling that the transaction was a lease and that the lessor would be treated as the owner for Federal income tax purposes.

The guidelines were not by their terms a definitive statement of legal principles and were not intended for audit purposes. Thus, if a taxpayer failed to satisfy all the requirements of the guidelines, a transaction might still be considered a lease if, after considering all facts and circumstances, the transaction was a lease under the general principles described above.

The specific requirements for obtaining a ruling under the guidelines were as follows:

(1) *Minimum investment.*—The lessor was required to have a minimum 20-percent unconditional at-risk investment in the property.

(2) *Purchase options.*—In general, the lessee could not have an option to purchase the property at the end of the lease term unless, under the lease agreement, the option could be exercised only at fair market value (determined at the time of exercise). That rule precluded fixed price purchase options, even at a bona fide estimate of the projected fair market value of the property at the exercise date.

(3) *Lessee investment precluded.*—Neither the lessee nor a party related to the lessee could furnish any part of the cost of the property.

(4) *No lessee loans or guarantees.*—As a corollary to the prior rule, the lessee could not loan to the lessor any of the funds necessary to acquire the property. In addition, the lessee could not guarantee any loan to the lessor of funds necessary to acquire the property.

(5) *Profit and cash flow requirements.*—The lessor had to expect to receive a profit and have a positive cash flow from the transaction independent of tax benefits.

(6) *Limited use property.*—Under Rev. Proc. 76-30, 1976-2 C.B. 647, property that could be used only by the lessee (limited use property) was not eligible for leveraged lease treatment.

Nontaxable use restriction on the investment credit

Overview

Under prior law sections 48(a)(4) and (5), property "used by" a tax-exempt organization in an exempt function or by a governmental unit generally was ineligible for the investment credit, including the investment credit for energy property. For this purpose, the term governmental unit included the United States Government, any State or local government, most international organizations, and any instrumentality of any of the foregoing. The term tax-exempt organization was defined to mean most organizations that were exempt from Federal income tax, such as a charitable or educational organization.

To determine whether property was subject to the nontaxable use restriction, it was first necessary to evaluate the economic substance of the transaction under the general principles for determining who was the tax owner of the property.[2]

Under the nontaxable use restriction, the investment credit was unavailable with respect to property that was treated for Federal income tax purposes as being owned by a governmental unit or a tax-exempt organization for use in its exempt function. In addition, property leased to a governmental unit or a tax-exempt organization for use in its exempt function was generally subject to the nontaxable use restriction. In addition to several statutory exceptions, however, one court held (and the IRS ruled) that the investment credit could be claimed where the governmental unit essentially contracted for a service, to be provided by the owner of property, rather than for the use of the property itself.

Statutory exceptions to the nontaxable use restriction

Tax-exempt organizations.—Certain farmers' cooperatives described in section 521 (which are considered exempt from tax even though they are subject to the rules of subchapter T, relating to cooperatives and their patrons) were excluded from the restriction on use by a tax-exempt organization. Also, the credit was allowed for property used by a tax-exempt organization in a taxable unrelated trade or business.

Foreign governmental units.—Although international organizations generally were subject to the restriction, property used by the International Satellite Consortium, the International Maritime Satellite Organization, and any successor organizations was excluded from the restriction on governmental use. Foreign governments and possessions of the United States were not subject to the restriction. Thus, a computer leased to the United States Government was denied the credit, but the credit was allowed for a computer leased to a foreign embassy located in the United States.

Rehabilitated buildings.—Rehabilitation tax credits were available for qualified rehabilitation expenditures incurred for older buildings used by tax-exempt organizations or governmental units as lessees. Where a tax-exempt entity owned a building that was leased to a taxpayer and the taxpayer/lessee made qualifying rehabilitation expenditures, a rehabilitation tax credit was allowed to

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[2] Rev. Rul. 68-590, 1968-2 C.B. 66. Rev. Rul. 68-590 involved arrangements between a taxable corporation and a political subdivision of a State providing for the tax-exempt financing, construction, and operation of an industrial project. The IRS did not apply the nontaxable use restriction even though the governmental unit held legal title under a sale-and-leaseback. Rather, the IRS held that the corporation was the tax owner of the property. The IRS reasoned that, in view of the economic substance of the arrangement, the sale-leaseback arrangement was nothing more than a security device for the protection of the holders of the tax-exempt bonds.

the taxpayer/lessee because the lessee (and not the tax-exempt lessor) was viewed as owning the improvements. *See, e.g.*, LTR 8441012 (July 9, 1984).

Foreign persons.—Property used by foreign persons was not subject to the nontaxable use restriction. Special rules (discussed below) applied if the property was used predominantly outside the United States."

"Casual or short-term lease" exception

Treasury regulations provided an exception to the nontaxable use restriction for property that was leased on a "casual or short-term basis" (Treas. Reg. sec. 1.48-1(j) and (k)).

Casual leases.—The term "casual lease" was interpreted to mean a lease that lacked the formalities inherent in a written lease.[3] Another example of a casual lease was the lease of an automobile from a car rental company by a governmental employee traveling on governmental business.[4]

Short-term leases.—The exception for short-term leases was recognized as a means of allowing the government to fulfill an unforeseen or extraordinary need for obtaining the short-term use of property from the private sector, without causing the taxpayer to lose the credit.[5] Thus, property not ordinarily intended for lease to a tax-exempt organization or governmental entity could have been leased for a short period in unforeseen or extraordinary circumstances.

In determining whether the exception for short-term leases applied, the courts rejected the contention that the relevant consideration was whether the nonqualifying use constituted a substantial portion of the useful life of the property.[6] The courts also rejected the position that short-term use should be determined on the basis of the minimum legally enforceable period of a lease.[7]

"Service contract" exception

Internal Revenue Service rulings.—Under Treasury regulations (sec. 1.48-1(j) and (k)), property used by a governmental unit or tax-exempt organization included property owned by or leased to one of those nontaxable entities. In Rev. Rul. 68-109, 1968-1 C.B. 10, the IRS ruled that property provided to a governmental unit as an integral part of a service was not "used by" the government within the meaning of prior-law section 48(a)(5).

Rev. Rul. 68-109 involved communications equipment installed by a public utility on the premises of governmental units. In ruling that the taxpayer's agreements with its customers were not sales or leases, but rather service contracts, the IRS relied on the fact that the taxpayer retained all ownership in and possession and control over the equipment. The IRS also focused on the fact that the communications equipment was part of an integrated network

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[3] *See, Xerox Corporation* v. *United States*, 656 F.2d 659, 666 (Ct. Cl. 1981) (note 13).

[4] Id.

[5] *World Airways, Inc.* v. *Commissioner*, 564 F.2d 886 (9th Cir. 1977), aff'd 62 T.C. 786 (1974).

[6] *World Airways Inc.* v. *Commissioner*, 62 T.C. 786 (1974), aff'd, 564 F.2d 886 (9th Cir. 1977).

[7] Thus, the mere fact that a lease contained a cancellation clause did not result in application of this exception. *Xerox Corporation* v. *United States*, 656 F.2d 659 (Ct. Cl. 1981); *Stewart* v. *U.S.*, 77-2 U.S.T.C. 9648 (D. Neb. 1977).

used to render services to the customer, not property placed with a user to allow it to provide services to itself.

The IRS issued a number of other rulings, including private rulings,[8] interpreting the service contract exception. For example, the investment credit was denied in situations involving trucks operated under a service contract by government employees (Rev. Rul. 72-407, 1972-2 C.B. 10) and school buses operated by a private party under contract with a local school district (LTR 8104001 (February 27, 1980)). In LTR 8217040 (January 27, 1982), the IRS allowed the investment credit in a situation involving a time charter of a vessel to the Federal government. The IRS ruled that the taxpayer could claim an investment credit for the vessel based on the taxpayer's representations that the taxpayer bore the risk of loss with respect to the vessel, the taxpayer had to retain possession and control over the vessel, the taxpayer was required to provide maintenance and secure insurance for the vessel, the taxpayer had to furnish and control the crew of the vessel, and the time charter transferred no legal interest in the property to the Federal Government.

The case law.—In *Xerox Corporation* v. *United States*, 656 F.2d 659 (Ct. Cl. 1981), a manufacturer provided duplicating machines to the Federal Government. The IRS had issued a revenue ruling involving the same basic facts as in *Xerox* that held that the agreements were leases (Rev. Rul. 71-397, 1971-2 C.B. 63). The Court of Claims rejected the taxpayer's contention that its agreements were short-term leases eligible for an exception to the governmental use restriction. The court held, however, that the machines were eligible for the investment credit because they were provided as an integral part of a service contract.

The Court of Claims based its decision on the IRS's own formulation of the service contract exception, as set forth in the holdings of published and private rulings (other than Rev. Rul. 71-397). The court rejected the government's contention that the service contract exception could never apply where the customer's own personnel operate the machines, because this factor was present in the first ruling adopting the exception (*i.e.*, Rev. Rul. 68-109). The court emphasized that *Xerox* was not a case in which the cost or rental value of the property dominated the price of the total arrangement. The court also noted that, conceivably, its decision would have been different if Treasury regulations had formulated the precise confines of the service contract exception.

Although the published and private rulings did not articulate any single test for use in determining whether an agreement was a service arrangement or a lease, the court concluded that the factors deemed common to service contracts in those rulings related to two broad areas of inquiry: (1) the nature of the possessory interest retained by the taxpayer and (2) the degree to which the property supplied was a component of an integrated operation in which the taxpayer had other responsibilities.

In holding that the interest conveyed to the customer was not sufficient to constitute a leasehold interest, the *Xerox* court focused

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[8] Although a private ruling is not binding as precedent on the IRS with respect to taxpayers other than the taxpayer who received the ruling, or the courts, a private ruling is helpful in interpreting the law in the absence of other authority.

on the following factors drawn from the IRS rulings in which a service contract was held to exist: (1) the taxpayer retained ownership of the machines, (2) the taxpayer decided whether to repair, replace, or alter the machines, and the customer was prohibited from altering or moving the machines, (3) the taxpayer bore the cost of adjustments, repairs, and replacements, (4) the taxpayer was responsible for loss or damage, except in the case of the customer's negligence, and (5) the customer could cancel upon 15 days notice.

Finally, in holding that the taxpayer's contractual arrangements could reasonably be deemed to be within the purpose of the investment credit, the court focused on the fact that the taxpayer manufactured machines for all customers, not just the government, and that governmental use occurred with respect to only five or six percent of the taxpayer's machines.

Foreign-use limitations

Overview

Property "used predominantly outside the United States" was subject to reduced ACRS deductions and was ineligible for the investment credit (secs. 168(f)(2) and 48(a)(2)).

In general, property "used predominantly outside the United States" was defined as property used outside the United States for more than half of the taxable year. There were a number of exceptions to this general rule. For example, communications satellites were excepted from the rules for foreign-use property. U.S.-flag vessels operated in the foreign or domestic commerce of the United States were excepted, as were aircraft registered by the Federal Aviation Agency and operated to and from the United States [9] or operated under contract with the United States, even if operated by a foreign airline. Special rules were also provided for certain rolling stock, drilling rigs, motor vehicles, containers, submarine cable, and other property.

ACRS deductions

The recovery period for computing ACRS deductions for recovery property used predominantly outside the United States was equal to the present class life (midpoint life) for the property, as of January 1, 1981, under the prior law Asset Depreciation Range (ADR) system. For personal property for which there was no ADR midpoint life as of January 1, 1981, a 12-year recovery period was used. The determination of useful lives based on facts and circumstances was not permitted. The owner of foreign-use personal property generally was allowed to use the 200-percent declining balance method of depreciation for the early years of the recovery period and the straight-line method for later years.

For foreign-use real property (including all components of a building), the recovery period was 35 years. The owner of foreign real property was generally allowed to use the 150-percent declin-

[9] The IRS ruled that a plane returning to the United States only once every two weeks qualified as being operated to and from the United States. Rev. Rul. 73-367, 1973-2 C.B. 8. Furthermore, an airplane could be leased for temporary use outside the United States without any investment credit recapture. Under section 47(a)(7)(A), three and one-half years qualified as temporary use for this purpose.

ing balance method for the early years of the recovery period, switching to the straight-line method in later years.

In the case of foreign-use personal property or real property, the straight-line method of depreciation could be used in lieu of the prescribed accelerated methods. In addition, for foreign-use personal property, the taxpayer could elect the straight-line method over one of the longer recovery periods allowed for domestic property (but the period elected could not be shorter than the ADR mid-point life, or, for property without an ADR mid-point life as of January 1, 1981, 12 years). For foreign-use real property, the taxpayer could elect to use the straight-line method over a recovery period of 45 years (instead of 35 years).

Reasons For Change

Overview

The Congress believed that reform of the tax law was essential, insofar as it related to property used by tax-exempt entities under a lease, a lease formulated as a service contract, or other similar arrangements. When tax-exempt entities used property under these arrangements, they paid reduced rents that reflected a pass-through of investment tax incentives from the owner of the property. Tax-exempt entities thereby benefitted from investment incentives for which they did not qualify directly and effectively gained the advantage of taking income tax deductions and credits while having no corresponding liability to pay any tax on income from the property. In this way, investment incentives that were intended to reduce the tax on taxable entities were turned into unintended benefits for tax-exempt entities, including foreign entities. The benefits were equivalent to an open-ended spending program, operated within the tax system, that increased the Federal deficit, encouraged tax-exempt entities to dispose of the assets they owned and forego control over the assets they used, disordered public budgeting processes, and fed a popular perception that the tax system was open to manipulation.

The Congress was greatly concerned about these problems, the scale of which was magnified by a surge in leasing to tax-exempt entities and other arrangements devised to transfer tax benefits to them. In response, the Act restricts tax benefits for property used by tax-exempt entities so that the erosion of Federal tax receipts will be eliminated and tax-exempt entities will lease property on the same tax-free basis as they can purchase it.

Background

In 1962, the Congress first enacted the investment tax credit for certain property used in a trade or business or for the production of income. The purpose of the credit was to reduce the income tax liability of taxpayers and thereby encourage their purchase and use of capital goods. When enacting the investment credit, the Congress expressly disallowed it for property used by governmental units and tax-exempt organizations, which of course have no income tax liability to reduce. The nontaxable use restriction was necessary to prevent these tax-exempt entities from indirectly gaining—through leasing, for example—the benefits of both tax-exemption and the income tax credit. This policy has been continued to the present. It is grounded in the fundamental principle that the tax system exists to collect taxes from taxable entities, not to make payments to tax-exempt entities.

The Congress believed that the policy of providing tax-reducing incentives to those who are subject to the income tax and denying them to those who are not subject to the income tax should be maintained, and that three major amendments were needed to improve its application. The amendments relate to (a) accelerated depreciation deductions, (b) transactions structured to avoid the denial of the investment credit, and (c) the treatment of foreign tax-exempt entities.

Accelerated depreciation deductions

Over the last two decades, the Congress has acted to accelerate cost recovery (depreciation) deductions for property used in a trade or business or for the production of income. The introduction of the Asset Depreciation Range system in 1971 and the enactment of the Accelerated Cost Recovery System in 1981 were two significant steps in this direction. The purpose of accelerating cost recovery deductions was to reduce the income tax liability of taxpayers in order to encourage their purchase and use of capital goods. Taking into account the time value of money, accelerated deductions reduced the present value of tax to be paid by deferring payment to later years.

The cumulative effect of legislation relating to cost recovery allowances was that these deductions currently operated, like the investment credit, as a significant investment incentive, by reducing the value of the tax that would otherwise be imposed on the income from the investment. Prior law, however, did not generally deny the benefits of accelerated cost recovery for property leased to tax-exempt entities. As a result, the transfer of benefits to these entities through the tax system, which the Congress acted to prevent with respect to the investment credit, occurred due to accelerated depreciation deductions. Therefore, the Act provides for less rapid write-offs of property used by tax-exempt entities.

Transactions structured to avoid investment credit restrictions

The value of the investment credit was sufficiently great to have prompted attempts to structure transactions in a form other than a lease, such that property used by a tax-exempt entity or dedicated primarily to its use could qualify for the credit. The Congress was concerned about the lack of statutory guidance for determining when property was in substance used by a tax-exempt entity. Therefore, the Act provides criteria for this purpose, so that the economically insubstantial restructuring of a lease as a service contract or similar arrangement will not result in unintended preferential tax treatment.

Foreign tax-exempt entities

The prior-law denial of investment credits for property used by tax-exempt entities was incomplete because it did not apply to certain types of property that was leased by foreign governments and other foreign persons who were not subject to Federal income tax.

As a result, this property qualified for greater tax benefits than property leased to the Federal Government, State or local governments, or tax-exempt domestic organizations.

The Congress concluded that tax benefits for property used by foreign tax-exempt entities should not exceed tax benefits for property used by domestic tax-exempt entities. The Congress was unconvinced that preferential treatment for foreign lessees of certain equipment should be maintained as an export subsidy. First, the benefits were available without regard to whether the equipment was produced in the United States. Thus, the Federal Government contributed to the foreign manufacture and use of equipment owned by a U.S. lessor. Second, the impact of the tax benefits in stimulating exports was diluted to the extent that they were retained by the lessor, rather than being flowed through to the foreign lessee as reduced financing costs. Third, to the extent that financing costs of the foreign lessee were reduced, they provided lower prices to foreign businesses for goods or services that were in direct competition with U.S. businesses. Fourth, preferential tax benefits for foreign governments to lease equipment placed them in a more favorable position than State and local governments. Fifth, the Congress was aware that direct credit assistance was available for exporters of U.S.-produced goods through the Export-Import Bank. Therefore, the Act does not except foreign lessees from the general policy of subsidy-free tax treatment for property used by tax-exempt entities.

The Congress was aware that the United States is a party to treaties that, on a reciprocal basis, exempt residents of the treaty partner from U.S. tax on certain shipping and aircraft income. Those provisions, however, do not in any way guarantee to residents of those countries the benefits of the investment tax credit or any accelerated depreciation regime.

Federal governmental entities

Federal government leasing presented a problem regarding accountability. If a Federal agency purchased property, the full cost of the property was reflected on the outlay side of the budget. If the agency leased the property from a taxable lessor, only part of the cost (the rental payments) was reflected on the outlay side of the budget. No account was taken of the impact on the revenue side of the budget resulting from tax incentives claimed by the lessor. Thus, the Federal agency's choice between purchasing and leasing was not based on a full measure of costs.

Additional reasons

The Congress had additional reasons for concluding that the tax benefits (in excess of tax exemption itself) available to tax-exempt entities through leasing should be eliminated.

First, the Federal budget is in no condition to sustain the substantial revenue loss resulting from leasing to tax-exempt entities, which would have increased as more tax-exempt entities, financial entities, and tax-oriented investors learned how to take advantage of the tax system in that way. The budget deficits would not decrease if spending cuts were matched or exceeded by revenue losses. These losses were especially large in transactions involving debt-financed property.[10]

Second, the Congress was concerned about possible problems of accountability of governments to their citizens, and of tax-exempt organizations to their clientele, if substantial amounts of their property came under the control of outside parties solely because the Federal tax system made leasing more favorable than owning. The Congress was convinced that the tax system should not encourage tax-exempt entities to dispose of the assets they owned or to forego control over the assets they used.

Third, the Congress believed that Federal aid to tax-exempt entities (above and beyond their tax exemption) should be made by appropriations rather than by tax benefits transferred through the tax system. The tax benefits in leasing were open-ended and hence uncontrollable in amount and composition, whereas appropriations are limited and adjustable to current priorities from year to year. Moreover, tax benefits appear in the Federal budget only as reduced tax collections, unassociated with any particular public purpose. Thus, with Federal aid conveyed through the tax system, it was very difficult to discover what tax-exempt purposes were Federally assisted, by how much they were assisted, and whether the assistance was rendered in ways consistent with other objectives of public policy. These matters can be known, debated, and decided in the appropriations process.

Fourth, the Congress was concerned about waste of Federal revenues. Although under prior law tax benefits existed to be shared by the tax-exempt user of property and the taxable owner, there was no assurance that the tax-exempt entity would be the prime beneficiary. For example, when a substantial portion of the benefit was retained by lawyers, investment bankers, lessors, and investors, the Federal revenue loss became more of a gain to financial entities than to tax-exempt entities. In proportion to that inefficiency, the Treasury lost more than $1 to provide $1 of aid to tax-exempt entities through leasing, whereas the aid could have been provided on a dollar-for-dollar basis through appropriations. This problem existed within the Federal Government also. To the extent that a Federal agency as lessee paid rents that did not reflect a full passthrough of the lessor's income tax benefits, the Federal Government paid more to lease an asset than it would to buy it.

Fifth, the Congress stressed the need to sustain popular confidence that the tax system is generally working correctly. A system that enticed Federal agencies not to own their essential equipment, nor colleges their campuses, nor cities their city halls, and which also rewarded taxpayers who participated in such transactions with a lighter tax burden, risked eroding that confidence.

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[10] With respect to tax benefits for debt-financed property, see Joint Committee on Taxation staff pamphlet, "Description of S. 1564 Relating to Tax Treatment of Property Leased to Tax-Exempt Entities" (JCS-34-83).

Explanation of Provisions

a. Overview

In general, the Act reduces the tax benefits that would otherwise be available for tangible property used by tax-exempt entities. The Act defines the term "tax-exempt entity" to include Federal, State, local, and foreign governments, possessions of the United States, international organizations, certain instrumentalities of the foregoing, and certain foreign persons, as well as most organizations that are exempt from Federal income tax or were exempt at any time within a prescribed five-year period.

For all Federal income tax purposes, the Act provides criteria for use in determining whether an arrangement characterized by the parties as a "service contract" or carrying some other label should be treated as a lease. The Act creates no inferences regarding the prior-law treatment of purported service contracts under the non-taxable use restriction on the investment credit.

To the extent a rehabilitated building is tax-exempt use property, rehabilitation credits are denied.

Special rules are provided for qualified technological property, property subject to short-term leases, and certain other property.

The prior-law rules for determining the owner of property for income tax purposes are unchanged. Thus, the Act leaves open the possibility that a tax-exempt entity could be treated as the owner of property under a purported lease, service contract, or other arrangement. The Act creates no inferences regarding who should be treated as the tax owner of property involved in such a transaction under prior-law rules.

b. Definition of tax-exempt entity

Domestic governmental entities

For purposes of both the depreciation and investment credit provisions, the term tax-exempt entity generally includes the United States, any State (including the District of Columbia) or local governmental unit, any possession of the United States (including Puerto Rico), and any agency or instrumentality of any of the foregoing. The Act provides an exception to the definition of tax-exempt entity for a corporate instrumentality of the United States, or of any State or political subdivision thereof, where (1) all of the corporation's income is fully subject to U.S. income tax, and (2) neither the United States nor any State or political subdivision thereof selects (or has the right to select) a majority of the board of directors or members of a comparable governing body of such instrumentality.

Tax-exempt organizations

The term tax-exempt entity also includes any organization, other than a farmers' cooperative described in section 521, that is exempt from United States income tax (including, *e.g.*, a section 401(a) qualified trust) and any organization that was exempt from United States income tax (other than by virtue of section 521) at any time during the five-year period ending on the date the property involved is first used by such organization (or any successor organization engaged in substantially similar activities). The Act does not treat property owned by any such former tax-exempt organization as tax-exempt use property. Thus, a tax-exempt entity may reduce its own tax liability by use of tax benefits attributable to property that it owns. In addition, property that is leased to the Federal Home Loan Mortgage Corporation (the tax-exempt status of which was repealed by the Act) is not treated as leased to a tax-exempt entity under the five-year rule.

Example.—A tax-exempt hospital has historically leased or owned automobiles for use in carrying out its tax-exempt function. On January 15, 1984, the hospital creates a wholly owned taxable subsidiary to lease new automobiles to provide transportation services to the hospital. Automobiles leased by the subsidiary at any time prior to January 15, 1989, will be tax-exempt use property.

Election for certain cooperatives.—An organization that was tax-exempt under section 501(c)(12) (relating to certain cooperatives) at any time during the 5-year period ending on the date the property involved is leased to such cooperative (or any successor organization that is engaged in substantially similar activities), but that is not tax-exempt at the time the property involved is leased to the organization, will not be treated as a tax-exempt entity if it makes an election to remain taxable for the period beginning with the taxable year the property is placed in service and ending with the 15th taxable year after the expiration of the recovery period of the property. This rule applies only if the organization complies with certain transitional rules (described below).

Arbitrage profits.—Under the transitional rules, the organization must elect to pay taxes on the exempt arbitrage profits it earns or has earned on that portion of the proceeds of any tax-exempt obligations associated with its financing (*e.g.*, acquisition or construction financing) of the property ultimately leased. The requirement was imposed because, in general, the Congress did not believe that a tax-exempt entity should be able to earn tax-free arbitrage profits on tax-exempt obligations issued to finance property and then, after becoming a taxable entity, be entitled to additional tax benefits by leasing the property. This is especially true in the case of cooperatives, which tend to have substantial tax planning flexibility.

This requirement applies with respect to all such exempt arbitrage profits, regardless of when earned, but only to the extent they are attributable to a period during which the organization was exempt from taxation. Under the Act, these profits are taxed to the organization for the first taxable year in which it uses the property under the lease. They are treated as a separate basket of taxable income and taxed as such under section 11. No deductions are allowed against that separate basket of income. Neither are any credits allowed with respect to resulting tax liability."

Exempt arbitrage profits" are the aggregate amount determined under the principles of sections 103(c)(6)(D)(i) and (ii) (relating to certain arbitrage profits), as amended by the Act, except that for this purpose, sections 103(c)(6)(F)(i)(II) (relating to certain earnings on a bona fide debt service fund) and 103(c)(6)(F)(ii) (relating to earnings on certain temporary investments) are disregarded. Furthermore, the principles of section 103(c)(6)(D)(i) are applicable for this purpose regardless of that section's general effective date. (Generally, that section applies to bonds issued after December 31, 1984.) If new section 103(c)(6)(D)(i) in fact is applicable to the tax-exempt obligations, there are, for purposes of this requirement, no exempt arbitrage profits. In general, if new section 103(c)(6)(D)(i) is applicable, certain arbitrage profits must be rebated to the United States. In such a case, taxation of "exempt arbitrage profits" is inappropriate.

Foreign entities

The term tax-exempt entity includes any foreign government, any international organization, any agency or instrumentality of either of the foregoing, and any other person who is not a United States person, but only with respect to property not more than 50 percent of the gross income, if any, derived by the foreign person or entity from the use of which is subject to United States income tax for the taxable year of the foreign person or entity. Income of the foreign person that is included in the gross income of a U.S. shareholder under section 951 for the shareholder's taxable year in which or within which the taxable year of the foreign person ends is treated as being subject to U.S. income tax for this purpose. In determining whether the more-than-50-percent threshold is satisfied, the portion of the gross income derived by the foreign person from the use of the property that is subject to U.S. income tax is determined by taking into account all exclusions and exemptions, whether derived from a statute, a treaty, or otherwise, but total gross income from the use of the property is to be determined without regard to any such exclusions or exemptions.

The term foreign person or entity does not include a foreign partnership or other foreign pass-through entity. Special rules for the treatment of partnerships and other pass-through entities (including foreign partnerships and other pass-through entities) are discussed below.

c. Tax-exempt use property

Personal property

For purposes of the depreciation provisions of the Act, the term tax-exempt use property includes that portion of tangible property (other than 15-year real property, 18-year real property, and low-income housing, collectively referred to as "18-year real property") that is leased to a tax-exempt entity. Except to the extent modified by the provisions of the Act dealing with service contracts or similar arrangements, the determination of whether personal property is leased to a tax-exempt entity is made under prior law rules. Thus, for example, if a taxable entity manufactures personal property for purchase by a tax-exempt entity in a normal commercial transaction, the property used by the manufacturer to produce the property sold to the tax-exempt entity is not treated as tax-exempt use property.

Qualified films (as defined in section 48(k)(1)(B)) and sound recordings (as defined in section 48(r)) distributed to foreign persons or entities are not treated as leased to them.

Real property

In general

For purposes of the depreciation provisions of the Act, 18-year real property is treated as tax-exempt use property to the extent it is leased to a tax-exempt entity, but only if at least one of the following circumstances (a disqualified lease) exists:

(1) All or a part of the property was financed with the proceeds of tax-exempt obligations and the tax-exempt entity (or a related party) participated in such financing;

(2) The lease contains or is accompanied by (i) a fixed or determinable price purchase option exercisable by the tax-exempt entity (or a related party), (ii) a fixed or determinable price sale option pursuant to which the lessor can require the tax-exempt entity (or a related party) to purchase the property, or (iii) the equivalent of either such option;

(3) The lease occurs after a sale, or other disposition or transfer of the property by, or lease of the property from, the tax-exempt entity (or a related party) and the property was used by the tax-exempt entity (or a related party) more than three months before the lease; or

(4) The lease has a term exceeding 20 years.

35-percent threshold.—Notwithstanding the above, no portion of any 18-year real property is treated as tax-exempt use property unless more than 35 percent of the property is leased to a tax-exempt entity or tax-exempt entities under a lease or leases of a type or types described above. For purposes of this rule, a building will be treated as a separate property unless two or more buildings are part of one project. In the latter case, the entire project will be treated as one property. Furthermore, disqualified leases to different tax-exempt entities (regardless of whether they are related) will be aggregated in determining whether property is tax-exempt use property and the extent thereof.

Measure of tax-exempt use.—The extent to which property is tax-exempt use property will be measured by those factors producing the greatest percentage of tax-exempt use. For example, assume that a tax-exempt entity sells a building, leasing 50 percent of it back for more than 20 years and leasing the other 50 percent back for 10 years. Because the entire building was sold and leased back, the entire building is tax-exempt use property even though only one-half of it is leased to the tax-exempt entity for a term exceeding 20 years. On the other hand, assume that a tax-exempt entity that leases 50-percent of a building for five years has an option to purchase the entire building at a fixed price. Absent other factors, only 50-percent of the building is tax-exempt use property since the tax-exempt entity is leasing only 50 percent of the property.

A tax-exempt entity or entities will be treated as leasing more than 35 percent of a building only if it or they lease more than 35 percent of the net rentable floor space in the building. Net rentable floor space does not include common areas.

Examples.—The following examples illustrate the application of the rules for determining whether and to what extent 18-year real property is tax-exempt use property. Assume that a tax-exempt entity participates in industrial development bond financing for the acquisition of a new building by a taxpayer. The tax-exempt entity leases 80 percent of the building for five years. Eighty percent of the building is tax-exempt use property under the Act. If the tax-exempt entity leased only 30 percent of the building for five years, no portion of the building would be tax-exempt use property. If the tax-exempt entity leased only 20 percent of the building for five years and another tax-exempt entity leased 20 percent of the building for a term in excess of 20 years (or a related entity leased 20 percent of the building for five years), 40 percent of the building would be tax-exempt use property. If the tax-exempt entity leased only 20 percent of the building for five years and an unrelated tax-exempt entity leased 10 percent of the building for five years, no part of the building would be tax-exempt use property. If the tax-exempt entity leased 75 percent of the building for a term exceeding 20 years, 75 percent of the building would be tax-exempt use property (without regard to whether industrial development bonds were used).

Participation in tax-exempt financing

Whether a tax-exempt entity (or a related party) will be treated as having participated in financing the acquisition of all or a part of the property through tax-exempt obligations depends on all the circumstances. A tax-exempt entity will be treated as having participated if it (or a related tax-exempt entity) issues the obligations and it is reasonable to expect at the time of issuance that the tax-exempt entity will be a user of all or a portion of the property. A tax-exempt entity will also be treated as having participated in the financing if, prior to the financing, it commits to lease space in the building. For example, an organization described in section 501(c)(3) will be treated as having participated in a bond financing if, prior to the issuance of the bonds, it commits to enter into a lease of all or part of the property after it has been acquired by the taxpayer. If a tax-exempt entity finances the acquisition or construction of a building with tax-exempt obligations, sells the new building to the taxpayer before using it, and then leases all or a part of it, the tax-exempt entity will be treated as having participated in the financing.

Purchase or sale options

A fixed or determinable price purchase or sale option exists if the tax-exempt entity (or a related party), directly or indirectly, has a legally enforceable option to buy the property involved from the lessor, or the lessor has a legally enforceable right to "put" the property to the tax-exempt entity (or a related party), at either a pre-established price or at a price that is determinable pursuant to a formula. An option or put at fair market value at the time of exercise will not be treated as a fixed or determinable price option or put. Nor will an option or put be so treated if the selling price is determinable pursuant to a formula which the parties, when agreeing to it, reasonably expected would produce a number approximately equal to fair market value at the time of exercise. An option to purchase in 15 years for an amount equal to 50 percent of original cost is treated as an option at a fixed or determinable price. An option to purchase at a price derived by a formula which incorporates rents then paid by taxable entities for the use of the same or similar property and then-prevailing interest rates is not treated as an option at a fixed or determinable price, so long as the price actually determined approximates fair market value at the time of exercise.

Any provision that has the effect of passing on to the lessee or a related party the risk that the property's residual value will decrease will be treated as the equivalent of a fixed or determinable price put. For example, assume that a tax-exempt entity leases land to a taxable entity for 20 years. The taxable entity constructs a building, which has an economic useful life of 50 years, on the land and leases it to the tax-exempt entity for the balance of the term of the ground lease. Because the tax-exempt entity has dominion over the building for its entire economic useful life, the tax-exempt entity may be treated as its tax owner under present law. If, however, the tax-exempt entity is not treated as the owner, the property would be treated as tax-exempt use property in any event because the tax-exempt entity has the equivalent of a fixed price purchase or sale option. Similarly, a lease is treated as containing the equivalent of a determinable sale option if the lease provides that if the lessee cancels or fails to renew the lease or if the property involved is destroyed, the lessee will pay or cause to be paid to the lessor the difference between the amount necessary to preserve the lessor's net economic return and the fair market value of the property.

An option need not be contained in the lease. it may be a separate agreement. An option to buy or put stock in a corporation (or equity interests in any other entity) that owns the property may be treated as an option to buy or put the property.

Uses after transfers

The lease of property to a tax-exempt entity after a disposition or other transfer of the property by the entity (or a related party) includes all forms of transactions in which a tax-exempt entity (or a related party), directly or indirectly, sells, leases, disposes of, or otherwise transfers property theretofore used by it (or a related party) which is then leased to the tax-exempt entity. For example, if a tax-exempt entity contributes a building to a partnership and leases back 50 percent of the building for five years, 50 percent of the property is tax-exempt use property. As a further example, if property is owned by a corporation that is owned by a tax-exempt entity, a sale or other disposition of the stock of that corporation will be treated as a sale or other disposition of the property by the tax-exempt entity. Finally, property owned by a tax-exempt entity (or a related party) which is subsequently leased to the tax-exempt entity pursuant to one overall arrangement will be tax-exempt use property regardless of the identity of the person from whom the lessor obtained the property. For example, assume that a tax-exempt entity sells a building to a taxable entity. The taxable entity sells or contributes the building to a partnership which, pursuant to one overall plan, leases it to the tax-exempt entity for five years. The building is tax-exempt use property.

If a tax-exempt entity disposes of its ownership interest in a property before that property is placed in service by the tax-exempt entity (or a related party), the tax-exempt entity will not be treated as having used the property. For example, assume that a tax-exempt entity contracts to have a building constructed. Before the building is substantially completed, the tax-exempt entity assigns the construction contract to a taxpayer and agrees to lease the building from the taxpayer upon its completion. The property will not be treated as having been sold and leased back.

Exception.—If a tax-exempt entity (or a related party) disposes of its ownership interest in 18-year real property and the property is leased to the tax-exempt entity within three months after it was first used by the tax-exempt entity (or the related party), the property is not treated as having been sold and leased back for purposes of the use after transfer rule.

Lease term

For rules relating to the length of a lease term, see the discussion below.

Improvements

For purposes of determining whether 18-year real property is tax-exempt use property, improvements to property (other than land) will not be treated as separate property. For example, if a governmental unit issues tax-exempt obligations, the proceeds of such issue are used by a taxpayer to acquire a building shell from a third party, and the taxpayer improves the building shell using other funds and then leases the improved building to the governmental unit, the governmental unit is treated as having participated in the tax-exempt financing of the entire property. Similarly, if a tax-exempt entity sells a building used by it for more than three months to a taxpayer and the taxpayer rehabilitates the building and leases the rehabilitated building back to the tax-exempt entity, the tax-exempt entity is treated as using one property after a sale-leaseback.

On the other hand, if unimproved land is disposed of by a tax-exempt entity, a building is constructed on the land by the new owner, and the improved land is leased to the tax-exempt entity, the building will not be treated as having been the subject of a sale-leaseback.

Tax-exempt use property does not include improvements constructed by a taxable entity on underlying land or other property leased from a tax-exempt entity merely because the tax-exempt entity is the owner of the land or other property. For example, assume that a municipality leases a certified historic structure to a taxable entity for 20 years. The taxable entity rehabilitates the structure, using industrial revenue bonds, in a rehabilitation qualifying under section 48(g), converting it into a shopping mall. The rehabilitated mall is leased by the taxable entity, piece-by-piece, to a variety of taxable merchants. No leasehold improvement is tax-exempt use property. The municipality, however, is the tax owner of the structure itself.

Other rules

Ultimate use of property

A determination that there is a tax-exempt use of property does not require that the ultimate lessee of the property be a tax-exempt entity. A disqualified lease at any point in a chain subjects the property to the Act. A similar rule applied with respect to the nontaxable use restriction of prior law. For example, assume that a corporation constructs a new convention center and leases it to a city under an arrangement in which the city has a fixed price option to buy after 20 years. The city subleases or licenses the property to a variety of taxable entities that use it. The entire structure is tax-exempt use property.

Similarly, if a U.S. corporation leases equipment to a foreign corporation not subject to U.S. tax and the foreign corporation subleases the equipment to a branch of a related U.S. corporation, the property is tax-exempt use property even though all income earned by the U.S. branch with respect to the use of the property is subject to U.S. tax. This result occurs without regard to the business reasons for the initial lease between the U.S. corporation and the foreign corporation. This result would not occur, however, if, in view of the economic substance of the overall arrangement, the transaction is properly treated for U.S. tax purposes as a lease directly from the U.S. corporation to the U.S. branch, and not as a lease to and sublease from the foreign corporation.

Nor can a tax-exempt entity avoid the provisions of the Act merely by being a sublessee. Thus, if corporation A leases property to corporation B under a lease with a fixed price option and corporation B subleases the property to a tax-exempt entity, assigning its fixed price option to the tax-exempt entity, the property is treated as tax-exempt use property.

Determination of ownership of property

Whether the tax-exempt entity is the tax owner of the property will be determined under present law, without regard to the Act. For example, a tax-exempt entity may hold legal title to property, used by a taxable entity, as a security device in connection with an industrial revenue bond. If the tax-exempt entity is not the tax owner of the property, the mere fact that it has legal title will not cause the property to be treated as tax-exempt use property. *See* Rev. Rul. 68-590, 1968-2 C.B. 66.

Definition of "lease".—The Act defines the term "lease" to include any grant of a right to use property. The general rule that only property "leased" to a tax-exempt entity is "used" by that entity for purposes of the depreciation rules is not intended to change the rule of present law that a tax-exempt owner-lessor of property is not able to pass on any investment tax credits to a lessee. *See* Treas. Reg. sec. 1.48-4(a)(1)(i).

Property used in an unrelated trade or business.—Tax-exempt use property does not include any portion of a property if such portion is predominantly used by a tax-exempt entity directly, or, for purposes of the partnership rules, through a partnership of which the tax-exempt entity is a partner, in an unrelated trade or business the income of which is subject to tax under section 511. For purposes of this rule, property is not treated as predominantly used by the tax-exempt entity in an unrelated trade or business the income of which is subject to tax under section 511 merely because the property is debt-financed property subject to the rules of section 514.

d. Depreciation

General recovery period and method

In the case of tax-exempt use property, accelerated cost recovery deductions and any other deductions for depreciation or amortization are to be computed by using the straight-line method and disregarding salvage value. The recovery period for tax-exempt use property in the 18-year real property class is 40 years or 125 percent of the term of the lease, whichever is greater. The recovery period for all other tax-exempt use property is the mid-point life of the property as of January 1, 1981, under the ADR system, or 125 percent of the term of the lease, whichever is greater. Personal property that has no ADR life will be treated as having a mid-point life of 12 years. The rules with respect to tax-exempt use property override section 168(f)(2) (relating to recovery deductions for property that is used predominantly outside the United States). Property treated as leased to a tax-exempt entity under the Act's provisions for distinguishing service contracts and other arrangements from leases (see below) will be treated as leased to the tax-exempt entity for purposes of the Act's depreciation provisions.

Qualified technological equipment

The general depreciation provisions do not apply to "qualified technological equipment" (defined below) leased to a tax-exempt entity pursuant to a lease with a term of five years or less. Except as indicated below, the cost (disregarding salvage value) of qualified technological equipment leased to a tax-exempt entity pursuant to a lease with a term of more than five years is to be recovered using the straight-line method, a five-year recovery period, and the half-year convention.

In the case of property that is subject to a lease of more than five years and is used predominantly outside the U.S., which property would be subject to section 168(f)(2) otherwise, the Act's general depreciation provisions apply.

As with other property, whether qualified technological equipment purportedly leased to a tax-exempt entity is to be treated as owned for tax purposes by the tax-exempt entity will be determined under prior law. For example, if qualified technological equipment with an economic useful life of five years is purportedly leased for five years, the nominal lessee may be treated as the tax owner of the equipment.

The term "qualified technological equipment" means computers and related peripheral equipment, high technology telephone station equipment installed on a customer's premises, and high technology medical equipment. Only tangible personal property can constitute qualified technological equipment.

Definition of computers.—Computers are programmable electronically activated devices capable of accepting information, applying prescribed processes to it, and supplying the results of those processes with or without human intervention. Computers consist of a central processing unit containing extensive storage, logic, arithmetic, and control capabilities. The term related peripheral equipment means auxiliary machines (whether on-line or off-line) designed to be placed under the control of the central processing unit of the computer. Neither term includes any equipment which is an integral part of property that is not a programmable computer, any video games or other devices used by the user primarily for amusement or entertainment purposes, or any typewriters, calculators, adding or accounting machines, copiers, duplicating equipment, or similar equipment.

Definition of telephone station equipment.—High technology telephone station equipment includes only property described in ADR class 48.13 and installed on a customer's premises. Furthermore, property described in ADR class 48.13 that does not have a high technology content does not qualify.

Definition of medical equipment.—The term "high technology medical equipment" means any electronic, electromechanical, or computer-based high technology equipment used in the screening, monitoring, observation, diagnosis, or treatment of human patients in a laboratory, medical, or hospital environment. High technology medical equipment can include computer axial tomography scanners, nuclear magnetic resonance equipment, clinical chemistry analyzers, drug monitors, diagnostic ultrasound scanners, nuclear cameras, radiographic and fluoroscopic systems, Holter monitors, and bedside monitors. Incidental use of any such equipment for other purposes, e.g., research, will not prevent it from qualifying as high technology medical equipment.

Other rules.—For purposes of the rules regarding high technology telephone station equipment and high technology medical equipment, high technology equipment consists only of equipment which, because of a high technology content, can reasonably be expected to become obsolete before the expiration of its physical useful life. For example, telephone booths and telephones that include only a standard dialing feature are not high technology equipment. Telephones that include features such as an abbreviated dialing short program, an automatic callback, or conference call feature can qualify as high technology equipment. The exception applies only to terminal equipment that contains such extra features and not to terminal equipment used in conjunction with features offered through central office capacity.

Exceptions.—Qualified technological equipment does not include equipment which (1) is leased to a tax-exempt entity after its disposition by the same tax-exempt entity (or a related party) if the tax-exempt entity (or a related party) used it before the disposition, (2) is financed with tax-exempt obligations, or (3) is used by the Federal government or a tax-exempt instrumentality thereof. Such equipment will be subject to the general depreciation provisions. For purposes of (1), only property that is owned and used by a tax-exempt entity (or a related entity) for more than three months before the lease to the tax-exempt entity is treated as having been used by such entity before the transfer.

In addition, the Treasury is authorized to provide, by prospective regulations only, that any high-technology telephone station equipment or medical equipment is to be depreciated under the general depreciation rules rather than the special rules for qualified technological equipment. It is intended that the Treasury so provide only if it determines that such property cannot reasonably be expected to become technologically obsolete substantially before the expiration of its physical useful life.

Operating rules

If a taxpayer elects under ACRS to recover the cost of property over an optional recovery period that exceeds the recovery period prescribed by the Act, then the cost of the property is to be recovered over the longer period. Property which would be 18-year real property if it were recovery property is treated as 18-year real property. For 18-year real property, first-year deductions are to be determined on the basis of the number of months in the year in which the property is in service. For other property, the half-year convention used under prior law applies. For example, if the recovery period of property other than 18-year real property is 10 years, the cost recovery percentage will be 5 percent for the taxable year the property is placed in service by the taxpayer, 10 percent for each of the next 9 taxable years, and 5 percent for the eleventh taxable year.

Section 168(f)(12) of present law (relating to depreciation of certain property financed with industrial development bonds) does not apply to tax-exempt use property subject to one of the Act's depreciation provisions.

It is intended that regulations be promulgated under section 168(f)(13) (relating to changes in use of depreciable property) prescribing rules for the treatment of property the tax ownership of which has not changed but which either becomes or ceases to be tax-exempt use property some time after having been placed in service by the taxpayer. These regulations will not address the rehabilitation tax credit as to which a special rule applies (see the discussion below).

e. Investment tax credit

In general

As under prior law, the investment credit (including the investment credit for energy property) generally is denied for property (including qualified technological equipment) leased to or otherwise used by tax-exempt entities, regardless of whether it qualifies as tax-exempt use property. The Act expands the category of tax-exempt entities subject to the nontaxable use restriction and provides statutory guidelines for distinguishing a service contract or other arrangement from a lease (see below). Property that is leased to or otherwise used by a tax-exempt entity some time after having been placed in service will cease to be section 38 property at the time it is used by the tax-exempt entity with the result that all or part of the investment credit may be recaptured.

If personal property is used by a tax-exempt entity (and the use is not pursuant to a short-term lease as described below), investment credits are not available. This result follows even if the investment credit would otherwise be available under section 48(a)(2)(B) (relating to exceptions from the denial of investment credit for certain property used predominantly outside the United

States). For example, an aircraft leased to a foreign person or entity does not give rise to any investment credit even if it is operated to and from the United States, if 50 percent or less of the gross income derived by the foreign person or entity from the use of the aircraft is taxable in the United States. (For a special rule for certain leases of aircraft to foreign persons or entities, see the discussion below of the short-term lease exception.)

The Act modifies the prior-law exception that allows the rehabilitation credit for property used by a tax-exempt entity (including governmental entities and foreign persons or entities) as a lessee. Only expenditures attributable to the rehabilitation of any portion of a building that is (or may reasonably be expected to be) tax-exempt use property will fail to qualify for the credit. The excluded expenditures are taken into account, however, under section 48(g)(1)(C) in determining whether there has been a substantial rehabilitation of the building.[11] If all or a portion of the building becomes tax-exempt use property for the first time some time after the rehabilitation, rehabilitation credits may be recaptured at that time as if that portion of the building which becomes tax-exempt use property were disposed of. As under prior law, where a tax-exempt entity owns a building and a taxpayer/lessee makes qualifying rehabilitation expenditures, the taxpayer/lessee is treated as owning the improvements.

Example. —Assume that a taxpayer spends $30,000 rehabilitating a building. One-half of the rehabilitated building is then leased to a tax-exempt entity under circumstances that render the one-half tax-exempt use property. No rehabilitation credit will be allowed on the $15,000 in rehabilitation expenditures attributable to that part of the building which is tax-exempt use property. A rehabilitation credit will be allowed on the other $15,000 in rehabilitation expenditures. If the other one-half of the building first becomes tax-exempt use property some time later, rehabilitation credits on the $15,000 may be recaptured.

Thrift institutions

The lessor of property to a thrift institution is entitled to no greater a credit with respect to such property than the thrift institution would have been entitled to had it owned the property. Property used by a thrift institution under a short-term lease, as described below, is not subject to the rule. A thrift institution can avoid this rule, however, by electing to waive its rights to claim deductions for additions to bad debt reserves under any method other than the experience method. Any such election is irrevocable and applies for all taxable years of the electing thrift institution (and

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[11] Under prior law (sec. 48(g)(2)(b)(i)), expenditures could not count as qualified rehabilitation expenditures unless the taxpayer elected to depreciate the property resulting from such expenditures on a straight-line basis under section 168(b)(3). If the taxpayer financed those expenditures with the proceeds of an industrial revenue bond, section 168(f)(12) required that a straight-line method of depreciation be used. Some taxpayers were concerned that, in such a case, an argument could be made that the taxpayer may not technically have "elected" to use a straight-line method. Under the Act, the rule of prior-law section 48(g)(2)(b)(i) is amended so as not to apply to property with respect to which a straight-line method is required to be used under 168(f)(12). That rule is effective as if included in the amendment made by section 216(a) of TEFRA.

any successor engaged in substantially similar activities) beginning with the taxable year for which made.

f. Property used under certain service contracts

Property used under a purported service contract arrangement with a tax-exempt entity or any other entity is treated as leased to that entity if the arrangement is more properly characterized as a lease. The application of this rule does not preclude treating such an entity as the tax owner of the property under general principles of Federal income taxation. This provision applies to contracts under which property is used to provide services to or for the benefit of a tax-exempt entity or any other entity. The Act creates no inferences regarding the treatment of service contracts under prior law. Nor does the Act affect the prior-law rules for determining the treatment of management contracts under which a tax-exempt entity or any other entity performs services with respect to property owned by a taxpayer.

The service contract provisions apply for all purposes of the income tax provisions of the Internal Revenue Code to service contracts involving personal property or real property (without regard to whether the nominal service provider is the tax owner or the lessee of the property).

Factors to be considered

In determining whether a transaction structured as a service contract is more properly treated as a lease, the Act requires that all relevant factors be taken into account, including, but not limited to, whether (1) the service recipient is in physical possession of the property, (2) the service recipient controls the property, (3) the service recipient has a significant possessory or economic interest in the property, (4) the service provider bears any risk of substantially diminished receipts or substantially increased expenditures if there is nonperformance under the contract, (5) the service provider uses the property concurrently to provide services to other entities unrelated to the service recipient, and (6) the total contract price substantially exceeds the rental value of the property for the contract period.

Physical possession.—Physical possession of property by the service recipient is indicative of a lease. Property that is located on the premises of a service recipient, or located off the premises but operated by employees of a service recipient, is viewed as in the physical possession of the entity. Property is not treated as in the physical possession of a service recipient merely because the property is located on land leased to the service provider by the service recipient.

Control of the property.—The fact that the service recipient controls the property is indicative of a lease. A service recipient is viewed as controlling the property to the extent it dictates or has a contractual right to dictate the manner in which the property is operated, maintained, or improved. Control is not established merely by reason of contractual provisions designed to enable the service recipient to monitor or ensure the service provider's compliance with performance, safety, pollution control, or other general standards.

Possessory or economic interest.—A contract that conveys a significant possessory or economic interest to a service recipient resembles a lease. The existence of a possessory or economic interest in property is established by facts that show (1) the property's use is likely to be dedicated to the service recipient for a substantial portion of the useful life of the property, (2) the service recipient shares the risk that the property will decline in value, (3) the service recipient shares in any appreciation in the value of the property, (4) the service recipient shares in savings in the property's operating costs, or (5) the service recipient bears the risk of damage to or loss of the property.

Substantial risk of nonperformance.—Under a service contract arrangement, the service provider bears the risk of substantially diminished receipts or substantially increased expenditures if there is nonperformance under the contract by the service provider or any property involved. Facts that establish that the service provider does not bear any significant risk of nonperformance are indicative of a lease.

Concurrent use of property.—The concurrent use of the property to provide significant services to entities unrelated to the service recipient is indicative of a service contract.

Rental value of property relative to total contract price.—The fact that the total contract price (including expenses to be reimbursed by the service recipient) substantially exceeds the rental value of the property for the contract period is indicative of a service contract. If the total contract price reflects substantial costs that are attributable to items other than the use of the property subject to the contract, then the contract more closely resembles a service contract. Conversely, the fact that the total contract price is based principally on recovery of the cost of the property is indicative of a lease. A contract that states charges for services separately from charges for use of property is indicative of a lease.

Other service contract rules

A contract will be treated as a lease rather than a service contract if the contract more nearly resembles a lease. Although each of the relevant factors must be considered, a particular factor or factors may be insignificant in the context of any given case. Similarly, because the test for determining whether a service contract should be treated as a lease is inherently factual, the presence or absence of any single factor may not be dispositive in every case. For example, even if a service recipient does not have physical possession of property, the arrangement could still be treated as a lease after taking all other relevant factors into account.

Scope of service contract provisions

As indicated above, the provisions describing factors to be used to distinguish service contracts and other arrangements from leases are to apply for all Federal income tax purposes, even if no tax-exempt entity is involved. For example, assume a taxpayer and a public utility enter into a purported service agreement pursuant to which the taxpayer is to provide electrical energy to the public utility for resale by the public utility. If the arrangement is characterized as a lease of property to the public utility under the appropriate set of service contract criteria, the property is treated as used by the public utility for purposes of, *e.g.*, section 46(c)(3)(B) and section 167(l)(3)(A). Similarly, a so-called service contract will generate rents for purposes of section 543(a)(2) if, after application of the appropriate service contract criteria, the arrangement more nearly resembles a lease of property.

Examples

The following examples illustrate the application of the service contract provisions. In each of these examples, T is a taxpayer and E is a tax-exempt entity.

Example (1)

E, an agency of the Federal government, desires to obtain the use of a built-to-purpose vessel. A contractor arranges for the construction of the vessel and for the sale of the vessel to T. The contractor then leases the vessel from T, the shipowner, under a long-term bareboat charter. E and the contractor enter into a time charter with respect to the vessel. The time charter provides for the transportation of equipment, cargo, and personnel. Under the time charter, E has the right to designate the port of call and the cargo to be carried. The master, officers, and crew of the vessel are hired by the contractor, subject to E's approval. All officers of the vessel must qualify for a government "confidential" security clearance. In addition, the master, chief officer, and radio officer must qualify for a government "secret" security clearance. E reserves the right to station 28 permanent government personnel aboard the vessel and to assign up to 100 additional military personnel to the vessel. The master of the vessel is under the direction of the contractor as regards navigation and care of the cargo. E also has the right to cause alterations to be made to the vessel. E must make separate payments for "Capital Hire" (computed by reference to the amount required to repay, with interest or a guaranteed return, the debt financing and equity investment of T) and "Operating Hire" (which covers the cost of operating the vessel and the contractor's profit). Payments of Operating Hire are suspended or reduced when the vessel is not fully available for service; however, E must continue to pay Capital Hire during such period.

The time charter has an initial term of 5 years. E has the option to extend on similar terms the basic term for one to four successive renewal periods, for a total of 25 years. The useful life of the vessel is in excess of 30 years. E can terminate the time charter for convenience at any time during the renewal periods. Upon a termination for convenience or if E fails to exercise a renewal option, E is required to pay any difference between the proceeds of the sale of the vessel and the "Termination Value" set forth in the time charter. The "Termination Value" is an amount approximating T's unrecovered equity, remaining debt service, and tax liability generated by the vessel's sale. E has the option to purchase the vessel at any time after the end of the basic 5-year term for the greater of fair market value or Termination Value at the time of purchase. If E purchases the vessel, E can require that the contractor continue to operate the vessel under the same terms as set forth in the time charter. If the vessel is damaged, destroyed, or otherwise lost due to causes beyond the contractor's control, E must pay any difference between Termination Value and any insurance proceeds. Thus, E also bears the risk of damage to or loss of the vessel.

E may be considered the owner of the vessel under the general principles for determining ownership for Federal income tax purposes. If, however, T were considered the owner, E would be treated as having a leasehold interest in the property (and the vessel would be tax-exempt use property). In the latter case, the following facts would serve as the basis for the conclusion that E is treated as having a leasehold interest: (a) E has some control over the vessel in that E can direct that alterations be made, (b) E has a significant possessory interest because the time charter contemplates that the vessel's use will be dedicated to E for a substantial portion of its useful life, the requirement that Termination Value be paid shifts the risk that the vessel will decline in value to E, and E bears the risk of damage to or loss of the vessel, (c) T does not bear a substantial risk of nonperformance because payments of Capital Hire continue even if the vessel is unavailable for service, (d) regarding the rental value of the property relative to the total contract price, the test for a service contract is not satisfied since the Capital Hire represents payments for the cost of the vessel and the Operating Hire represents separate payments for services, and (e) all other relevant facts and circumstances, including the facts that the vessel was built-to-purpose and the terms of E's purchase option. The facts that the contractor (and not E) has physical possession of the vessel and that there is no concurrent use of the vessel to provide services to other persons are insignificant in the context of this case.

Example (2)

The facts are the same as in example (1) except that (a) E has no right to make alterations to the vessel, (b) E's obligation to pay charter hire is set at a rate per deadweight ton and is subject to the condition that the vessel be in full working order, (c) the time charter has an initial term of 5 years, with an option to renew for one to five one-year periods, for a total of 10 years, (d) T bears the risk of damage to or loss of the vessel, and (e) E has no option to purchase the vessel. In addition, E is not required to pay Termination Value (or any other penalty) if it fails to exercise a renewal option.

On these facts, the time charter will be respected as a service contract (and the vessel will not be tax-exempt use property). The following facts provide the basis for that conclusion: (a) E has no control over the vessel, (b) E has no possessory or economic interest in the vessel, (c) the contractor bears a substantial risk of nonperformance, since the contractor will receive no revenues if the vessel is unavailable for service, and (d) the facts do not indicate that any portion of the charter hire is based on the cost of the vessel.

Example (3)

E, a municipal agency, acquires an industrial park and then leases the facility to T, a taxable person, for a term in excess of 15 years. T substantially rehabilitates the facility, and then subleases the improved property to other taxable persons. T retains E to manage the property under a management contract.

T owns the improved portion of the facility. The mere fact that E controls the maintenance and operation of the property under a management contract does not provide a basis for treating the contract as a lease under the service contract provision. The Act leaves open the possibility that an arrangement structured as a management contract could be treated as a lease (under which the tax-exempt entity provides services to third parties for its own benefit). *See McNabb* v. *Commissioner*, 81-1 USTC 9143 (W.D. Wash. 1980) (where an arrangement structured as a management contract was characterized as a lease because the taxpayer did not adequately control the venture and did not bear the risk of loss); *Meagher* v. *Commissioner*, 36 T.C.M. 1091 (1977) (where the court held that an agreement was a management contract and not a lease, applying the same tests discussed in the *McNabb* case).

Example (4)

E, a school district, and T, a privately owned school bus company, enter into a multi-year agreement (up to 4 years) under which T will provide transportation for all enrolled school children within the district. T was awarded the contract under competitive bid and is paid, so long as it performs under the contract, at a fixed monthly rate. Under the agreement, T has the exclusive authority to designate bus stops and establish pickup and delivery schedules although it does consult with E. E designates the children to be transported and the time they are to be at school.

T has sole title to the buses, which generally have an economic useful life of 9.5 years, and has total discretion regarding the number and type of vehicles to be used. The agreement requires that all vehicles, equipment, and drivers must comply with applicable State and Federal safety regulations. Under the terms of the contract, T is responsible, subject to State requirements, for maintaining insurance coverage within specified limits. T is also responsible for the training and employing of drivers, and for the storage, repair, and maintenance, which is significant, of all vehicles. In addition, T decides when a bus should be replaced, determines what models should be purchased and what features they should have, and exercises discretion over substitution. It is unlikely the buses will be used for other purposes during the school year.

Absent other factors to the contrary, the agreement is a service contract. The following facts provide the basis for that conclusion: (a) T has physical possession of the buses; (b) T has control of the buses; (c) T bears a substantial risk of nonperformance in that, among other things, it will not be paid unless it performs; and (d) the monthly rate substantially exceeds the rental value of the property. The facts that the buses likely will not be used for other purposes during the school year, that the agreement is for up to 4 years (which is not a substantial portion of their useful lives), and that T must comply with applicable regulations do not, by themselves, support a conclusion that the agreement is a lease.

Exceptions

Arrangements involving solid waste disposal, energy, and water treatment facilities.—The Act provides an exception to the service contract provisions for contracts or arrangements involving solid waste disposal, energy, and water treatment works facilities. This exception creates no inferences regarding the treatment of property subject to the general service contract provision.

Qualified solid waste disposal facility.—The term "qualified solid waste disposal facility" is defined as any facility that provides solid waste disposal services for residents of part or all of one or more governmental units, if substantially all of the solid waste processed at such facility is collected from the general public. For purposes of this rule, the general public includes commercial businesses, but only if the waste collected from such businesses is collected from them in their capacities as members of the general public (and not as members of a limited group such as a group that generates waste not processable by normal waste facilities serving the public).

Other qualified contracts.—The exception also applies to a contract between a tax-exempt entity or other service recipient and a service provider involving (1) electrical or thermal energy produced at a cogeneration or alternative energy facility and sold to the recipient or (2) the operation of a water works treatment facility, as defined for purposes of section 212(2) of the Federal Water Pollution Control Act.

A cogeneration facility is a facility that uses the same source of energy for the sequential generation of electrical or mechanical power in combination with steam, heat, or other forms of useful energy. The term "alternative energy facility" is defined as a facility for producing electrical or thermal energy, the primary energy source of which is not oil, natural gas, coal, or nuclear power.

A contract or arrangement involving energy conservation or energy management services does not qualify for the exception. A transition rule is provided, however, under which, in the case of services performed pursuant to a binding contract with respect to energy conservation or energy management services entered into before May 1, 1984, prior law (rather than the Act's general services contract rules) applies.

Exception not to apply in certain cases.—The exception does not apply, and an arrangement will be subject to the general service contract provisions, if the tax-exempt entity or other purported service recipient (or a related entity) (1) operates the facility, (2) bears any significant financial burden if there is nonperformance under the contract (other than for reasons beyond the control of the service provider), (3) receives any significant financial benefit if operating costs of the facility are reduced as the result of technological changes or other efficiencies introduced by the service provider, or (4) has an option to purchase, or may be required to purchase, all or a part of the facility at a fixed and determinable price (other than at fair market value). An option or put that would not be treated as an option or a put at a fixed or determinable price under the rules regarding tax-exempt 18-year real property will not be treated as an option or a put at a fixed or determinable price for this purpose. The congress intended that, for purposes of this rule, the term "related party" generally be defined as in new section 168(j)(7), as described below.

In general, for purposes of determining whether a facility is eligible for the exception to the general service contract provision, a tax-exempt entity's or other recipient's right to inspect the facility, exercise its sovereign power (in the case of a governmental unit), or to act in the event of a breach of contract by the service provider are not to be taken into account. Similarly, the allocation of the benefits and burdens of change in law are not taken into account.

For purposes of determining whether a recipient bears a significant financial burden, the following factors are to be disregarded: (1) temporary shut-downs of the facility for repairs, maintenance, or capital improvements and (2) financial burdens resulting from the bankruptcy or other financial difficulty of the service provider.

The determination of whether the recipient receives a significant financial benefit as the result of certain reductions in operating costs is to be made without regard to (1) adjustments or payments based on increased production or efficiency, or (2) financial benefits generated by the recovery of energy or other products. A service recipient will not be deemed to be entitled to a financial benefit due to decreased operating costs merely because (1) the price per unit of energy delivered decreases as the amount of energy produced increases, or (2) the energy delivered is priced at the avoided cost.

Example (5)

E, a municipality, and T, a private company, enter into a solid waste disposal agreement under which T will construct, own, and operate a solid waste resource recovery facility (the Facility) on land leased from E. The Facility will process solid waste (of the type that is currently collected and disposed of as a part of normal municipal collections), generate steam, convert the steam to electricity, and recover ferrous metals from residual ash. T will invest 25 percent of the construction costs, and the balance will be financed with the proceeds of an issue of tax-exempt industrial development bonds to be issued by E. T will construct the project over a three-year period and operate it for 20 years. E has the option to purchase the Facility at the end of the 20-year term, at the then fair market value of the Facility. Pursuant to a related energy purchase agreement, U, a utility, will be required to purchase a minimum amount of steam during each year of the same 20-year period. Absent default by T, E will pay an annual fee based on the greater of 400,000 tons of solid waste, regardless of whether such amount is actually delivered, or the number of tons of solid waste actually delivered. The fee is subject to a downward adjustment to reflect increases in T's energy revenues. T bears the primary risks of cost overruns and construction delays. E is entitled to receive 80 percent of all interest-cost savings resulting from a financing or refinancing of the tax-exempt bonds at a reduced interest rate.

E can terminate the agreement on performance grounds. In that event, E might obtain possession of the Facility until a new operator is found. In addition, E's employees will be present at the Facility to perform tasks such as delivering the solid waste, carrying away the residue or ash, or monitoring T's compliance with contractual performance standards.

If the Facility is shut down, E remains obligated to make payments equal to 10 percent of the minimum annual fee. Also, in the case of a shut-down, E will incur costs for trucking and alternate disposal, which costs may approximate 150 percent of the fee that would otherwise be payable to T. If a shut-down is caused by the delivery of hazardous waste or other unsuitable materials, or by the imposition of Federal regulations prohibiting operation of the Facility, E will remain obligated to pay the minimum annual fee.

The Facility qualifies for the exception to the service contract provision because (a) the solid waste disposed of is collected from the general public, (b) E is not viewed as operating the property, notwithstanding the ability of E's employees to ensure that T complies with general performance standards or the tasks performed by such employees at the Facility, (c) E does not bear any significant burden if there is nonperformance under the contract (other than for reasons beyond T's control), (d) E will not benefit from a reduction in operating costs attributable to efficiencies introduced by T, and (e) E's purchase option is at fair market value.

Example (6)

E, a municipality, enters into a long-term solid waste disposal service contract with T, the operator. The contract obligates T to design, construct, and operate a 2,000 ton per day solid waste disposal resource recovery facility for an annual charge (computed as the cost of debt service on bonds issued to finance the facility, plus a fixed annual operation fee escalated for inflation, minus T's 90% share of the revenues derived from the sale of electricity produced by the facility). T has the option to purchase the facility at the expiration of the contract term at the then fair market value. T concurrently enters into a facility loan agreement with P, a public authority, providing for a loan to T of the proceeds of tax-exempt industrial development bonds issued by P to finance a portion of the cost of the facility and the construction of the facility by T to performance standards. The facility loan agreement provides that if T fails to construct a solid waste disposal facility capable of processing at least 1,500 tons per day of solid waste within 5 years. T must, as liquidated damages, pay or provide for the payment of P's bonds, and thereupon will have no further obligation. Neither the service contract nor the facility loan agreement entitles E to any damages in the event of T's nonperformance. Should T fail to perform its obligations to build a plant with a waste throughput capacity of at least 1,500 tons per day, E will suffer costs and expenses associated with having planned, developed, and negotiated for service from an inoperable plant, costs of developing a replacement disposal arrangement, and costs of transporting and landfilling waste that was expected to be disposed of at the original facility. Although the financial burdens to E from T's nonperformance may be significant, they arise from the continuing duty of E to dispose of waste and are not directly caused by T's nonperformance. The facility therefore does not constitute property leased to E.

Example (7)

T, a private company, and E, a Federal government agency, enter into a contract under which T will construct and operate a solar energy system (the System). The System will be owned by a group of private investors. The System will be constructed on the roof of a building owned by E. All of the hot water and steam produced by the System will be sold to E under a long-term contract. E must pay a significant penalty if it defaults on the contract. However, T will receive no revenues under the contract unless the System produces energy. T is solely responsible for the operation and maintenance of the System. Because the System is substantially maintenance free, the total contract price exceeds the rental value of the System by only 5 to 10 percent. Upon expiration of the contract, E has the option to purchase the System at the then fair market value.

The agreement between E and T is a service contract because (a) the contract provides for the sale of energy to E and the energy is produced by an alternative energy facility, (b) E does not operate the System, (c) E does not bear any significant financial burden if there is nonperformance under the contract, (d) E does not receive any financial benefit if T's operating costs are reduced, and (e) E's purchase option is at fair market value.

Example (8)

E, a public utility, and T, a related company, enter into a purchase power agreement, under which E is the sole purchaser of electricity generated by an alternative energy system owned by T. E sells the electricity to consumers at rates regulated by the State public utilities commission and based on E's cost of service. The rates cover E's capital costs and expenses in providing utility service and include a fair rate of return allowed by the commission on E's investment in providing that service. The commission prescribes a uniform system of accounts for E to follow in preparing its financial report to the commission. T, although related to E, is not a public utility company. T does not sell its services on a regulated cost-of-service basis. The State public utility commission requires the parties to deal strictly at arm's length. The commission's rulings will effectively prevent E from sharing any risk of the system's nonperformance or decline in value, loss, or damage.

Regardless of the terms of the purchase power agreement, the agreement does not qualify for treatment under the exception to the service contract provisions for alternative energy facilities because E and T are related parties. Thus, the determination of whether the transaction is more properly characterized as a lease must be made under the general service contract provisions. In the circumstances described above, the fact that T and E are related parties is relevant but not necessarily dispositive under the general service contract provisions.

Low-income residential property.—Low-income residential property operated by or for an organization described in section 501(c)(3) or section 501(c)(4) is not subject to the service contract or other arrangement rules. Thus, for example, the leasing of units in such property to occupants is not treated as use by or on behalf of such an organization. For purposes of this rule, low-income residential property means property described in section 1250(a)(1)(B)(i), (ii), (iii), or (iv), but only if 80 percent or more of the units are leased to low-income tenants, determined in a manner consistent with section 167(k)(3)(B). prior law continues to govern the tax treatment of arrangements involving this type of property.

g. Treatment of partnerships and other pass-through entities and other arrangements

The Congress was concerned that taxpayers and tax-exempt entities might attempt to structure transactions to avoid the restrictions of the Act. Transactions of this character might include the use of partnerships or other pass-through entities. To deal with those transactions, the Act contains two anti-abuse provisions.

Property owned by partnerships

Where property is owned by a partnership of which a tax-exempt entity is a member and an allocation to the tax-exempt entity is not a qualified allocation (defined below), an amount equal to such entity's proportionate share of the property is treated as tax-exempt use property. Solely for purposes of this rule, if a tax-exempt entity's share of income or loss of the partnership would be treated as income or loss from an unrelated trade or business under section 511 (without regard to the debt-financed income rules of section 514), then the property will not be treated as tax-exempt use property.

Qualified allocations.—A qualified allocation is an allocation to a tax-exempt entity that (1) is consistent with the tax-exempt entity's being allocated the same distributive share (i.e., the identical percentage) of each and every item of partnership income, gain, loss, deduction, credit, and basis (excluding allocations with respect to contributed property) and such share remains the same during the entire period that the entity is a partner, and (2) such allocation has a substantial economic effect, as defined under the rules applicable to partnership allocations generally (sec. 704(b)(2)). A tax-exempt entity's proportionate share of property is such entity's share of partnership items of income or gain (excluding certain built-in gain with respect to contributed property), whichever results in the largest proportionate share. If a tax-exempt entity's share may vary during the period such entity is a partner, the entity's proportionate share is the highest share the entity may receive under the partnership agreement.

The Act provides for the application of similar rules to other pass-through entities (such as a trust).

Property that is co-owned.—The Act does not change the prior-law rule for determining the tax status of property that is co-owned by a tax-exempt entity under an arrangement that is not classified as a partnership for Federal tax purposes. Thus, a tax-exempt entity will continue to be viewed as owning a separate undivided interest in property held by a joint venture that is classified as a co-tenancy rather than a partnership under Federal tax law. *Cf.* Rev. Rul. 78-268, 1978-2 C.B. 10 (which addresses this issue in the context of applying the prior-law nontaxable use restriction on the investment credit).

Property leased to partnerships

Property leased to a partnership or other pass-through entity having a tax-exempt entity as a partner or beneficiary is treated as leased to each such partner or beneficiary, in an amount equal to its proportionate share of the property (as determined under the Act). Similar rules apply to tiered partnerships and other tiered pass-through entities.

Arrangements other than service contracts

The Act provides that an arrangement other than a service contract (including but not limited to a partnership or other pass-through entity) is to be treated as a lease if such arrangement is properly treated as a lease. In determining whether any given arrangement is more properly treated as a lease, all relevant factors are taken into account, including factors similar to those set forth in the general service contract provision. This provision is applicable to any arrangement, other than a service contract, under which a tax-exempt entity or any other entity directly or indirectly (e.g., by use of a taxable subsidiary to serve as a partner in a partnership) obtains the use or benefits of property.

Example (9)

E, a not-for-profit domestic hospital, and T, a partnership composed of individuals who are active members of E's medical staff, enter into a joint venture to acquire and operate a computer axial tomography (or "C.A.T.") scanner. The C.A.T. scanner will be used solely to aid in the diagnosis of diseases of E's patients. Each joint venturer will contribute equal amounts of debt and cash towards the purchase price of the property, and will share equally in net profits and losses and net cash flows, and other partnership items. It is assumed that these allocations have substantial economic effect. The C.A.T. scanner, which will be located on the premises of E, will be operated by members of T. The day-to-day business of the joint venture will be managed by a representative of each joint venturer. Under the joint venture agreement, T will be responsible for the billing of all technical charges and will receive two percent of gross charges for costs associated with preparing, mailing, and collecting charges. E will bill the joint venture and be reimbursed for occupancy costs (including utilities, housekeeping services, building depreciation, and interest) relating to the location of the C.A.T. scanner on its premises. The joint venturers will be separately responsible for interest, taxes, and insurance relating to participation in the joint venture. However, as between E and T, E is ultimately liable for the debt service obligations with respect to the entire property. The joint venture will terminate at the end of seven years. The useful life of the C.A.T. scanner is approximately nine years. Within six months of termination, T can require that E purchase T's interest in the joint venture at fair market value, adjusted upward if fair market value is less than a price specified in the contract (which price is computed by reference to the amount required to repay T's equity investment with a guaranteed return, less the net profits received by T during the term of the joint venture).

Assuming that the joint venture is properly classified as a partnership rather than a co-tenancy for Federal tax purposes, there is, absent other factors, a qualified allocation. Accordingly, none of the property is tax-exempt use property under the first of the two anti-abuse provisions.

The joint venture agreement is also subject to the provision relating to arrangements other than service contracts that purport not to be leases. The property, by virtue of its use for E's patients, is being used for the benefit of E. In addition, the property is not used in an unrelated trade or business. Under the Act, taking into account factors similar to those enumerated in the general service contract provision, the arrangement is treated as conveying to E a leasehold interest in T's interest in the property. Thus, it is tax-exempt use property under the second anti-abuse provision. The following facts provide the basis for this conclusion: (a) although no payments are required to be made by E to T, T will be compensated through payments made by E's patients and by the terms of the put, (b) E has control of T's interest in the property because E has an equal voice in the operation and maintenance of the entire property, (c) E has a possessory interest in T's interest because the property will be used under the agreement for a substantial portion of the property's useful life and E bears the risk that the property will decline in value by virtue of the put held by T, (d) T does not have the right to use the property to provide services to anyone other than a patient of E, and (e) all other relevant facts, including the facts that the use of the property is integrally related to E's tax-exempt function, that E has guaranteed the repayment of the total acquisition indebtedness, and that the property will be operated only by E's employees. Given the totality of the facts and circumstances, the fact that T bears a risk of substantially diminished receipts is mitigated by E's obligation to fulfill T's debt service requirements and does not provide a basis for a contrary conclusion.

Because the C.A.T. scanner qualifies for the exemption for qualified technological equipment, the cost of T's interest is recovered over 5 years. The C.A.T. scanner is, however, ineligible for the investment credit.

Other rules

The partnership rules apply notwithstanding any other provision of the Act. For example, assume that a partnership owns a building which is leased to a taxable entity. The partnership has one tax-exempt entity as a partner, and its proportionate share is 10 percent. Unless the partnership's allocations to the tax-exempt entity are qualified, 10 percent of the building is tax-exempt use property, notwithstanding the 35-percent threshold otherwise applicable in the case of 18-year property. This rule does not apply, however, under the rule discussed above, to the extent the rental income from the lease is treated as unrelated trade or business income that is subject to tax under section 511 (determined without regard to the debt-financed income rules of section 514).

Property may be tax-exempt use property under both the general provisions of the Act and the special partnership provision. For example, a tax-exempt entity may be a partner in a partnership owning a building 60 percent of which is leased to a tax-exempt entity under a long-term lease. Sixty percent of the building is tax-exempt use property under the general provisions. The status of the other 40 percent would depend on whether the allocations with respect to it are qualified.

If a portion of a partnership's depreciable property is tax-exempt use property, total partnership depreciation deductions allowable for each taxable year with respect to that property are reduced. The partnership's total depreciation deductions as reduced can be allocated under the partnership agreement among one or more of the partners in accordance with the provisions of section 704(b).

The reference to allocations of basis in determining whether an allocation is a qualified allocation pertains to allocations of basis of oil and gas properties under section 613A(c)(7)(D) and "section 38 property" under the investment credit rules.

Issues to be addressed in regulations

The Treasury is authorized to prescribe regulations dealing with the effect of guaranteed payments (as defined in sec. 707(c)) under this rule. Under those regulations, priority cash distributions to partners that constitute guaranteed payments should not disqualify an otherwise qualified allocation so long as the priority cash distributions are reasonable in amount (*e.g.*, equal to the appropriate Federal rate) and are made to all partners in proportion to their capital in the partnership. On the other hand, it is expected that the regulations will prevent partnerships from avoiding the qualified allocation rules by making disproportionate guaranteed payments for services or the use of partner capital.

The Treasury is also authorized to prescribe regulations pursuant to which, in appropriate cases, particular items may be excluded or segregated in determining whether there is a qualified allocation. One example involves a U.S. corporation and a foreign country that are equal partners in a partnership created under the laws of that foreign country. Under those laws, the U.S. corporation's share of the partnership's profits may be taxed, but not the foreign government's share. The tax, in form, may be imposed on and paid by the partnership rather than the U.S. corporation directly. Under the partnership agreement, all partnership items may be allocated equally between the two partners except that the tax expense may be allocated to the U.S. corporation and cash distributions to the partners may reflect that allocation. Assuming those allocations possess substantial economic effect, the partnership agreement should not be treated as containing an allocation that is not qualified.

Another situation the regulations might address involves a partnership which, in substance, consists of several partnerships formed to explore for, develop, and produce oil and gas. Typically, a partner in such a partnership may select to what extent he wishes to participate in a particular well, and his interest in the income, gain, loss, deduction, credit, and basis may differ from well to well. For example, a partner, consistent with the partnership agreement, may contribute 75 percent of the cost of one well and 50 percent of the cost of a second well and be allocated 75 percent of all tax items from the first well and 50 percent of all tax items from the second. If instead of using one partnership to invest in several wells, a separate partnership were used for each well, the allocation formula used for each well could be different from the others and yet each could satisfy the qualified allocation rules. It is expected that the regulations will grant relief in this and similar nonabusive situations.

It is expected that regulations will provide that the determination of whether a tax-exempt entity's share may vary is made without regard to changes resulting from the tax-exempt entity's purchase or sale of an interest in the partnership, a contribution to the partnership by any partner, or a distribution of property by the partnership, provided these transactions are the result of contemporaneous arm's-length negotiations, the parties have adverse interests, the allocations to the tax-exempt entity are qualified after the change, and the change does not have the effect of avoiding the restrictions of the Act. The application of these rules is not to result in more than 100 percent of any partnership property being treated as tax-exempt use property.

Another area that the regulations might address involves the application of the rules for property owned by a partnership to a domestic partnership that has a foreign person or entity as a partner. For purposes of the definition of a foreign person or entity, the Act provides that a foreign person is not treated as a tax-exempt entity if more than 50 percent of the income derived by such person from the use of the property is subject to U.S. tax. It may be appropriate to provide a regulatory exception for property owned by a foreign person or entity through a partnership where the foreign person's income from the partnership is subject to full U.S. tax.

Similarly, it is expected that the regulations will provide that an allocation will not disqualify an otherwise qualified allocation on the basis that it does not have substantial economic effect in cases where such allocation is not governed by the substantial economic effect rules (*e.g.*, an allocation of basis of an oil and gas property) or cannot, by its nature, satisfy those rules (*e.g.*, an allocation of credits, deductions attributable to nonrecourse debt, and percentage depletion in excess of basis), provided such allocation complies with the relevant section of the Code or the regulations (*e.g.*, section 613A(c)(7)(D) and proposed regulations section 1.704-1(b)(4)). Furthermore, the regulations might provide a procedure for taxpayers to seek rulings that an allocation will be treated as qualified in cases not specifically addressed by the regulations.

Foreign partnerships

Under the Act, property leased to a foreign partnership or other foreign pass-through entity is not, solely by reason of the fact that the lessee is a foreign entity, treated as tax-exempt use property. Unless the taxpayer establishes otherwise, however, for purposes of the general rule for the treatment of property that is leased to a partnership, all partners of a foreign partnership (and all beneficiaries of any other foreign pass-through entity) are treated as foreign persons or entities.

h. Short-term lease exception

Depreciation

Property will not be treated as tax-exempt use property under the depreciation provisions by reason of being subject to a short-term lease to a tax-exempt entity. For purposes of this rule, the term of a lease begins when property is first used under it. In the case of property other than 18-year real property, a lease of less than one year or 30 percent of the property's ADR mid-point life (but not greater than three years), whichever is greater, will qualify as a short-term lease. In applying the Act's depreciation provisions with respect to 18-year real property, a lease of less than three years will qualify as a short-term lease.

Investment credits

Under the investment credit (not including the rehabilitation credit) provisions, generally, property used by a tax-exempt entity under a lease having a term of less than six months will not be treated as used by the tax-exempt entity.

Under a special rule, property will be treated as leased for a short term if the term of the lease does not exceed the greater of one year or 30 percent of the property's ADR mid-point life, if the property is leased to a foreign person or entity and is either (1) used in offshore drilling for oil and gas (including drilling vessels, barges, platforms, drilling equipments, and support vessels with respect to such property), or (2) a container described in section 48(a)(2)(B)(v) (determined without regard to the place of use) and container chassis and container trailers having an ADR mid-point life of not more than six years.

The Act provides a special investment credit rule for certain aircraft leased to a foreign person or entity before January 1, 1990. Under section 47(a)(7), use under certain leases of certain aircraft predominantly outside the U.S. will not trigger investment credit recapture until the aircraft has been so used for more than three and one-half years. Absent a special rule, leases of such aircraft to a foreign person or entity for six months or more would generally trigger investment credit recapture. Under the Act, leases described in section 47(a)(7) to a foreign person or entity of aircraft described in section 47(a)(7) will not trigger investment credit recapture if those leases do not exceed three years. If such aircraft is thereafter disposed of or otherwise ceases to be section 38 property, investment credit recapture will be determined by disregarding the term of the lease to the foreign person or entity.

The rehabilitation credit is denied by reason of a lease to a tax-exempt entity only if the rehabilitated property is tax-exempt use property. Under the Act, rehabilitated property is not treated as tax-exempt use property if the lease to the tax-exempt entity has a term of less than three years.

i. Lease term

For all purposes of the Act, the term of a lease includes all periods with respect to which the tax-exempt lessee has a legally enforceable option to renew, or the lessor has a legally enforceable option to compel renewal, whether the lease is in fact renewed and regardless of the terms at which the lease is renewable. In the case of 18-year real property, however, an option to renew by the lessee at fair rental value (determined at the time of renewal) is not treated as an option to renew.

Under the Act, the lease term is measured by counting certain successive leases as one lease. This rule applies if the original lease and one or more successive leases are entered into as part of the same transaction or a series of related transactions with respect to the same or substantially similar property.

The Act leaves open the possibility that the term of a subsequent lease could be included in the term of the original lease if the circumstances indicate that the parties, upon executing the original lease, had informally agreed that there would be an extension of the original lease. An extension at a rental rate differing materially from the market rental rate at the time of the extension would suggest that the parties had such an informal agreement. Furthermore, rules similar to those applied under section 46(e)(3) (relating to investment credits for noncorporate lessors) are to be applied in determining the term of a lease. *See, e.g. Hokanson* v. *Commissioner*, 730 F.2d 1245 (9th Cir. 1984) (in which a reasonable expectations test was applied). The Congress intended that the *Hokanson* rule and similar rules take precedence over the rules regarding fair rental renewal options with respect to real property, so that, under all the facts and circumstances, the term of a fair rental value renewal option may be treated as a part of the original lease term.

j. International Maritime Organization and International Satellite Communications Organization

No special rules are provided for property used by Intelsat and Inmarsat. The rules relating to partnerships and other pass-through entities apply to these organizations. The Act does provide for the Treasury to conduct a study of the satellite industry and to report the findings to the Congress no later than April 1, 1985. The study will focus on the following issues: (1) whether and to what extent domestic satellite companies are now able to, and in the future may be expected to be able to, compete successfully with foreign satellite operations for both domestic and foreign business, (2) whether domestic satellite companies are now able to, and in the future may be expected to be able to, compete with each other on fair and equitable terms, (3) what role tax benefits play in permitting satellite companies to compete with each other on fair and equitable terms, and (4) whether Federal tax laws should be changed, and, if so, in what respect, to assure fair and open competition among all satellite companies.

k. Definition of related party

Each governmental unit and each agency or instrumentality of a governmental unit is related to each other such unit, agency, or instrumentality the rights, powers, and duties of which derive in whole or in part, directly or indirectly, from the same sovereign authority. Therefore, a multi-State commission is related to each of its member States, since the commission will be deriving its authority from those States. For purposes of this rule, the United States, each State (including the District of Columbia), each possession of the United States (including Puerto Rico), and each foreign country is a separate sovereign authority. Therefore, a city in one State will not be related to a city in another State under the rule. Each city in a foreign country, however, will be treated as related to every other governmental unit, agency, or instrumentality in that foreign country.

Any entity (other than a governmental unit or an agency or instrumentality of such a unit) is related to any other person if the two have (a) significant common purposes and substantial common membership or (b) directly or indirectly, substantial common direction. For example, the local chapter of a national fraternity or of the Red Cross is related to its national organization.

Any tax-exempt entity is related to any other entity if either owns 50 percent or more of the capital interests or the profit interests in the other. For example, a foreign person is related to its wholly owned subsidiary and any corporation that owns 50 percent or more of the value of its stock, and a section 501(c)(3) organization is related to any corporation 50 percent or more of the stock of which it owns. For purposes of this rule, an entity treated as related to any other entity under either of the two foregoing rules will be treated as the one entity. For example, assume that each of 10 cities within 1 State own 10 percent of a corporation. The State, each city and the corporation are related parties.

Any tax-exempt entity is related to any other tax-exempt entity with respect to a particular transaction if such transaction is part of an attempt to avoid the application of the Act.

l. Exceptions

The Act does not apply to those mass commuting vehicles exempted from most of TEFRA's amendments to the safe harbor lease provisions. See section 208(d)(5) of P.L. 97-248. Furthermore, the Act does not apply to property described in section 208(d)(3)(E) of P.L. 97-248, as amended by P.L. 97-448 (relating to certain boilers and turbines of rural electric cooperatives). Nor does the Act apply to property described in section 168(f)(12)(C)(ii) of prior law (relating to certain sewage or solid waste disposal facilities) if a ruling request relating to the tax consequences of the use of such property by a tax-exempt entity was filed on or before May 23, 1983.

m. Regulations

The Act provides that the Secretary is to prescribe such regulations as may be necessary or appropriate to carry out the purposes of new section 168(j). No such regulations are to be inconsistent with the Act, as reflected in its legislative history. The Act also authorizes the Secretary to prescribe present class lives for any property (other than section 1250 class property) that does not presently have a present class life.

Effective Dates

General

The Act generally applies to property placed in service by the taxpayer after May 23, 1983, except to the extent acquired by the taxpayer subject to a lease in effect on May 23, 1983. The Act also applies to property placed in service by the taxpayer before May 24, 1983, and used pursuant to a lease entered into or renewed after May 23, 1983. For purposes of the preceding sentence, a lease will not be treated as entered into or renewed after May 23, 1983, merely by reason of the exercise by a lessee of a written option, or performance under a contract, that was enforceable against the lessor on May 23, 1983, and at all times thereafter. Furthermore, the Act will not apply merely because a lessee under a lease entered into before May 24, 1983, subleases to a tax-exempt entity after May 23, 1983.

Property to which the Act does not otherwise apply under the foregoing rules will not become tax-exempt use property merely by reason of a transfer of the property subject to the lease by the lessor (or a transfer of the contract to acquire, construct, reconstruct, or rehabilitate the property), so long as the lessee (or the party obligated to lease) does not change.

For property used by the U.S. Postal Service, October 31, 1983 is substituted for May 23, 1983, in applying the rules described in the preceding paragraph.

Certain improvements to real property are not to be treated as separate property for purposes of the effective date rules. Under this provision, if the Act does not apply to the underlying real property, it will not apply to the improvements either. Improvements covered are those which would not be substantial improvements under section 168(f)(1)(C)(ii) if 20 percent were substituted for 25 percent.

Transitional rules

The Act provides three general transitional rules.

First transitional rule

Under the first transitional rule, the Act does not apply to property used by a tax-exempt entity pursuant to one or more written contracts that were binding on May 23, 1983, and at all times thereafter, which required the taxpayer (or a predecessor in interest under the contract) to acquire, construct, reconstruct, or rehabilitate the property and the tax-exempt entity (or a tax-exempt predecessor in interest under the contract) to use the property.

For example, assume that on February 1, 1983, a tax-exempt entity enters into a binding contract to have a building constructed. Construction is to be completed on January 15, 1984. On May 1, 1983, the tax-exempt entity assigns its interest in the construction contract to corporation X and enters into a binding contract to lease the building back from corporation X upon its completion. The first transitional rule applies. The first transitional rule would not apply if the assignment and entering into of the binding contract to lease did not occur until after May 23, 1983.

As a further example, assume that a tax-exempt entity has owned and occupied all of a building for years. On May 1, 1983, the tax-exempt entity enters into a binding contract with corporation Y pursuant to which the tax-exempt entity, on July 1, 1983, will sell the building to corporation Y and lease it back. The first transitional rule applies. The result would be the same even if corporation Y assigns its entire interest in the contract to corporation Z, or contributes it to a partnership of which it is a member, on June 1, 1983. The result would be the same if the tax-exempt entity assigned its interest in the lease to another tax-exempt entity on June 15, 1983.

A contract is binding only if it is enforceable under State law against the taxpayer (or a predecessor) and does not limit damages to a specified amount as, for example, by a liquidated damages provision. A contractual provision that limits damages to an amount no greater than five percent of the total contract price will not be treated as limiting damages. A contract is binding even if subject to a condition, so long as the condition is not within the control of either party (or a predecessor). A contract will not be treated as ceasing to be binding merely because the parties make insubstantial changes in its terms or if any term is to be determined by a standard beyond the control of either party. Finally, a contract which imposes significant obligations on the taxpayer (or a predecessor) will not be treated as non-binding merely because some terms remain to be negotiated. For example, if a corporation and a tax-exempt entity enter into a legally enforceable contract on May 1, 1983, pursuant to which the corporation agrees to buy a building from the tax-exempt entity and then lease it back, the contract will be treated as a binding contract to use notwithstanding the fact that some terms of the lease have not yet been set. In addition, for purposes of this rule, a written contract award made by the United States, or any agency or instrumentality thereof, on or before May 23, 1983 is to be treated as a binding contract.

On the other hand, a binding contract to acquire a component part for a larger piece of property will not be treated as a binding contract to acquire the larger piece of property. For example, if a tax-exempt entity entered into a binding contract on May 1, 1983, to acquire a new aircraft engine, there would be a binding contract to acquire only the engine, not the entire aircraft.

Second transitional rule

Under the second transitional rule, the Act does not apply to property that is leased to a tax-exempt entity if (1) the taxpayer (or a predecessor in interest in or under the contract) or the tax-exempt entity was required to acquire, construct, reconstruct, or rehabilitate the property pursuant to a contract that was binding on May 23, 1983 (or had commenced, but not completed, construction, reconstruction, or rehabilitation of the property by that date), (2) the taxpayer or the tax-exempt entity acquired the property after June 30, 1982, and before May 24, 1983, or (3) the taxpayer or the tax-exempt entity completed construction, reconstruction, or rehabilitation of the property after December 31, 1982, and before May 24, 1983, but only if, in any such case, the lease is pursuant to a written contract obligating the tax-exempt entity to use the property and entered into before January 1, 1985. Requirement (1), above, is not satisfied if the tax-exempt entity used the property before May 24, 1983. Property does not fail the completion-of-construction test merely because a certificate of completion was not issued. The second transitional rule does not apply if the tax-exempt user of the property is a foreign person or entity (including the members of a foreign partnership or other pass-through entity).

For example, assume that a tax-exempt entity acquires and begins using a building on June 1, 1982. On February 1, 1983, the tax-exempt entity enters into a binding contract to have the building substantially rehabilitated. The rehabilitation is to be started on March 1, 1983, and completed by May 1, 1984. By December 1, 1983, the tax-exempt entity enters into a binding contract to effect a sale-leaseback of both the original building and the rehabilitation. On these facts, the second transitional rule applies to the rehabilitation but not to the original building (since it was acquired and used before July 1, 1983).

For purposes of this transitional rule, the contract to acquire, construct, reconstruct, or rehabilitate need not be with the seller or the construction company. It is sufficient if the taxpayer (or a predecessor) or the tax-exempt entity has a contract with any third party requiring the taxpayer (or a predecessor) or the tax-exempt entity to acquire, construct, reconstruct, or rehabilitate. For example, a binding contract between a taxpayer and a tax-exempt entity pursuant to which the taxpayer is obligated to have property constructed for the tax-exempt entity qualifies as a binding contract for purposes of the second transitional rule. The other rules applicable under the first transitional rule with respect to assignments of contracts and binding contracts are equally applicable under the second transitional rule.

Third transitional rule

Under the third transitional rule, the Act does not apply to property leased to a tax-exempt entity where there was significant official governmental action with respect to the property involved or its design on or before November 1, 1983, and the lease is pursuant to a written contract, entered into before January 1, 1985, which obligates the tax-exempt entity to use the property. The third transitional rule does not apply if the tax-exempt user of the property is the Federal Government, any agency or instrumentality thereof, or a foreign person or entity, but can apply if the tax-exempt user is a State or local governmental unit or any other tax-exempt entity.

For example, assume that prior to November 1, 1983, a city council approved a plan providing for the rehabilitation of city hall. On December 1, 1983, the city enters into a binding contract to sell the rehabilitated city hall to private investors and lease it back. The third transitional rule is applicable with respect to the entire building, as rehabilitated.

For purposes of the third transitional rule, whether particular property is part of an approved project, or a project for which design work had been approved, depends on all the facts and circumstances, including the tax-exempt entity's plans on November 1, 1983.

A project (or design work with respect to a project) will be considered as having been approved by significant official governmental action if the governmental entity having authority to commit the tax-exempt entity to the project (or the design work), to provide funds for it, or to approve the project (or the design work) under State or local law took significant action indicating an intent to proceed with, provides funds for, or approve the project (or the design work) and it would be reasonable, under all the circumstances, to expect that the project (or the design work) would be carried out. As an example, assume that in December 1982, the State agency regulating hospitals in the State issues a certificate of need to a tax-exempt entity with respect to a specific hospital project. The official governmental action rule is satisfied.

The significant official governmental action rule contains three separate requirements. First, the action must be an official action. Second, the action must be specific action approving a particular project. And third, the action must be taken by a governmental entity having authority to commit the tax-exempt entity to the project, to provide funds for it, or to approve the project under State or local law.

Under the first requirement, the governmental entity must adopt a resolution or ordinance, or take similar official action, prior to November 1, 1983. The action qualifies only if it conforms with Federal, State or local law and is a proper exercise of the powers of the governmental entity. Moreover, the action must not have been withdrawn. Finally, written evidence of the action must have existed before November 1, 1983. Satisfactory written evidence includes a formal resolution or ordinance, minutes of meetings, and contracts with third parties pursuant to which the third parties are to render services in furtherance of the project.

The second requirement is directed at the substance of the action taken. The action must be a specific action with respect to a particular project in which the governing body indicates an intent to have the project (or the design work for it) proceed. This requires that a specific project have been formulated and that the significant official action be a step toward consummation of the project. If the action does not relate to a specific project or merely directs that a proposal or recommendation be formulated, it will not qualify. On the other hand, no plan to lease needs to have been formulated by November 1, 1983. Generally, a significant official action would include the hiring of bond counsel or bond underwriters necessary to assist in the issuance and sale of bonds to finance a particular project or the adoption of an inducement resolution relating to bonds to be issued for such a project. It would also include making application for an Urban Development Action Grant on behalf of the project described in the application or receipt of a governmental grant with respect to the project. It would also include the recommendation of a city planning authority to proceed with a project based on the results of an authorized feasibility study.

Under the third requirement, the action must be taken by a governing body (Federal, State, or local) having authority to commit the tax-exempt entity to the project, to provide funds for it, or to approve the project under applicable law. If the chief administrator (or executor) or another representative of a governmental entity has such authority, action by such representative would satisfy the official governmental action requirement so long as it qualified as official action and related to a particular project, regardless of whether such action could later be rescinded. A governing body may have the authority to commit the tax-exempt entity to a project notwithstanding the fact that the project cannot be consummated without other governmental action being taken. For example, a city council will be treated as having authority to commit a city to do a sale-leaseback of its city hall notwithstanding the fact that State law needs to be amended to permit such a transaction. Similarly, if a local project cannot be completed without Federal approval, either legislative or administrative, the obtaining of such approval will qualify as official governmental action.

The following actions also constitute significant governmental action: the enactment of a State law authorizing the sale, lease, or construction of the property; the appropriation of funds for the property or authorization of a feasibility study or a development services contract with respect to it; the approval of financing arrangements by a regulatory agency; the enactment of a State law designed to provide funding for a project; the certification of a building as an historic structure by a State agency and the Department of the Interior; or the endorsement of the application for a certification of need with respect to a medical facility by a regulatory agency other than the agency empowered to issue such a certificate.

Routine governmental action at a local level will not qualify as official governmental action. Routine governmental action includes the granting of building permits or zoning changes and the issuance of environmental impact statements.

Certain waste water treatment facilities

Waste water treatment facilities that are used by a tax-exempt entity and are not 18-year real property are to be depreciated on the straight-line method over 12 years, using the half-year convention and disregarding salvage value, if, by June 15, 1983, a city council approved entering into a lease and, by July 12, 1983, a resolution was adopted approving the issuance of industrial development bonds to finance acquisition of the facilities by the taxpayer.

Specific projects

Under the Act, transitional rules are provided for specific projects involving (1) substantial rehabilitations or new construction of buildings where a qualifying action occurred before November 1, 1983, and (2) rehabilitations of certain educational facilities with respect to which there was substantial reliance on prior law.

The Act does not apply to property described in section 168(c)(2)(D) (relating to 18-year real property), including improvements and without regard to whether the improvements constitute substantial improvements, if:

(a) the property is leased to a university and houses a basketball arena and university offices, and, on June 16, 1983, the Board of Administrators of the university adopted a resolution approving the rehabilitation of the property in connection with an overall campus development program;

(b) the property is leased to a charitable organization, the organization acquired the property on August 21, 1981, and, on June 12, 1982, an arson fire caused substantial damage to the property, delaying the planned rehabilitation;

(c) the property is leased to a corporation described in section 501(c)(3) (relating to certain organizations exempt from tax), pursuant to a contract that was entered into on August 2, 1983, and under which the corporation first occupied the property on December 22, 1983;

(d) the property is leased to an educational institution and used as an arts and humanities center, an architect was engaged to design a planned renovation in November 1982, a demolition contract was entered into in December 1983, and a renovation contract was entered into in March 1984;

(e) the property was acquired by a college in October 1981 for use as a dormitory, renovation plans were delayed because of a zoning dispute, and, in May of 1982, the court of highest jurisdiction in the State in which the college is located resolved the zoning dispute in favor of the college;

(f) the property is a fraternity house; in August 1982, the related university retained attorneys to advise the university regarding the rehabilitation of the property; on January 31, 1983, the governing body of the university established a committee to develop rehabilitation plans; on January 10, 1984, the governor of the State in which the university is located approved historic district designation for an area that includes the property; and on February 2, 1984, historic preservation certification applications for the property were filed with an historic landmarks commission;

(g) the property is leased to a retirement community with respect to which, on January 5, 1977, a certificate of incorporation was filed, and on November 22, 1983, the board of trustees of the retirement community adopted a resolution evidencing an intention to begin immediate construction of the property;

(h) the property is used by a university, in July 1982, the board of trustees of the university adopted a master plan for the financing of the property, and, as of August 1, 1983, at least $60,000 in private expenditures had been expended with respect to the project;

(i) the property is leased by a university for use as a fine arts center, and the board of trustees of such university authorized a sale-leaseback agreement with respect to such property on March 7, 1984;

(j) the property is used as an international trade center and, prior to January 1, 1982, an environmental impact study for such property was completed; on June 24, 1981, a developer made a written commitment to provide one-third of the financing for the development of such property; and on October 20, 1983, such developer was approved by the board of directors of the tax-exempt entity;

(k) the property is leased to a university of osteopathic medicine and health sciences and, on or before December 31, 1983, the board of trustees of such university approved the construction of such property;

(l) with respect to the property, there existed on May 23, 1983, architectural plans and specifications (within the meaning of section 48(g)(1)(C)(ii)); the property is leased to a tax-exempt entity after substantial improvements are made; and prior to May 23, 1983, at least ten percent of the total estimated cost of such improvements was paid or incurred; or

(m) the property is used as a convention center and, on June 2, 1983, the city in which the property is located provided for over $6 million for the project.

This transitional rule applies to property included in a project only to the extent that the project is completed substantially as contemplated at the time of and in the specified action.

Express appropriations

The Act does not apply to certain property leased to or used by the United States if, among other things, an express appropriation for rentals was made for the 1983 fiscal year before May 23, 1983.

Containers

Containers and certain related equipment placed in service before 1984, and used by foreign persons or entities before 1984, are exempted from investment credit recapture by reason of use by foreign persons or entities until 1985.

Partnerships

The Act's provisions regarding the treatment of property owned by partnerships (new section 168(j)(9)) are not intended to apply to property that was acquired by a partnership on or before October 21, 1983, or acquired after that date pursuant to a written contract that was binding on October 21, 1983 and at all times thereafter.[12]

In addition, the Act's provisions regarding the treatment of property owned by partnerships do not apply to any property acquired, directly or indirectly, before January 1, 1985, by a partnership if, (1) before October 21, 1983, the partnership was organized, a request for exemption with respect to such partnership was filed with the Department of Labor, and a private placement memorandum stating the maximum number of units in the partnership that would be offered had been circulated,

(2) the interest in the property to be acquired, directly or indirectly (including through acquiring an interest in another partnership) by such partnership was described in such private placement memorandum, and,

(3) the marketing of partnership units in such partnership is completed not later than two years after the later of the date of the enactment of the Act or the date of publication in the Federal Register of such exemption by the Department of Labor and the aggregate number of units in such partnership sold does not exceed the maximum number of units stated in the private placement memorandum referred to in (1), above.

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[12] An argument could be made, under the literal language of the statute, that this rule provides transitional relief from all of the Act's provisions (and not just section 168(j)(9)); a technical amendment will be recommended to clarify this point.

New section 168(j)(9) is also inapplicable to any property acquired directly or indirectly, before January 1, 1986, by a partnership if:

(1) before March 6, 1984, the partnership was organized and publicly announced the maximum amount (as shown in the registration statement, prospectus or partnership agreement, whichever is greater) of interests which would be sold in the partnership, and

(2) the marketing of partnership interests in such partnership was completed not later than the 90th day after the date of enactment of this Act and the aggregate amount of interests in such partnership sold does not exceed the maximum amount referred to in (1), above.For purposes of this rule, property will be deemed to have been acquired prior to January 1, 1986, if the partnership entered into a written binding contract to acquire such property prior to January 1, 1986 and the closing of such contract takes place within six months of the date of such contract (24 months in the case of new construction).

Scope of service contract rules; thrift institutions; rehabilitation credits

The service contract rules are not generally effective for arrangements entered into before November 5, 1983, if no tax-exempt entity is a party. In addition, the rule regarding investment credits for property leased to thrift institutions is generally effective with respect to leases entered into after November 5, 1983. Finally, the provision that disallows rehabilitation credits for tax-exempt use property is inapplicable to property that was leased to a tax-exempt entity on or before November 1, 1983, or after such date pursuant to a written contract entered into on or before November 1, 1983, which obligated the taxpayer to lease the property to the tax-exempt entity. If, however, part or all of the rehabilitated property was financed by tax-exempt financing and the tax-exempt entity (or a related party) participated in the financing, the general effective date rules apply for purposes of the provision that disallows rehabilitation credits.

Property used by foreign persons or entities

For property (other than certain aircraft for which a special rule is provided) leased to a foreign person or entity (including, for this purpose, any foreign partnership or other pass-through entity), the Act does not apply if (1) the taxpayer or the tax-exempt entity was required to acquire, construct, reconstruct, or rehabilitate the property pursuant to a contract that was binding on May 23, 1983 (or had commenced but not completed the activity by that date), (2) the taxpayer or the tax-exempt entity acquired the property after December 31, 1982, and before May 23, 1983, or (3) construction, reconstruction, or rehabilitation of the property was completed after December 31, 1982, and before May 24, 1983, but only if in any such case, the lease is pursuant to a written contract entered into before January 1, 1984, obligating the foreign person or entity to use the property. Requirement (1), above, is not satisfied if the foreign person or entity used the property before May 24, 1983.

In addition, for property used by a foreign person or entity, the Act does not apply if the property was placed in service by the taxpayer before January 1, 1984, and used by such foreign person or entity pursuant to a lease entered into before January 1, 1984. Under a special rule, property that is subleased to a foreign person or entity under a lease that qualifies for transitional relief under the preceding sentence, is not treated as tax-exempt use property by reason of the sublease if the property was used before January 1, 1984, by any foreign person or entity pursuant to the qualifying lease.

Under a special rule for wide-body, four-engine, commercial aircraft, the Act does not apply to aircraft leased to a foreign person or entity if the foreign person or entity entered into a written binding contract to acquire the aircraft on or before November 1, 1983. This rule applies only to aircraft placed in service prior to January 1, 1986. This rule was intended to apply to new aircraft (i.e., aircraft placed in service after May 23, 1983).

Revenue Effect

These provisions are estimated to increase fiscal year budget receipts by $264 million in 1984, $800 million in 1985, $1,553 million in 1986, $2,840 million in 1987, $4,711 million in 1988, and $6,724 million in 1989.

2. Treatment of Certain Motor Vehicle Operating Agreements as Leases (sec. 32 of the Act and sec. 7701 of the Code)[13]

Prior Law

Terminal rental adjustment clauses

Lease agreements for motor vehicles often contain a terminal rental adjustment clause. A terminal rental adjustment clause permits (or requires) an upward or downward adjustment of rent to make up for any difference between the projected value of a vehicle and the actual value upon lease termination.

Treatment of leases

Accelerated Cost Recovery System (ACRS) deductions and investment credits were allowed for motor vehicles used for a business or other income-producing purpose. These tax benefits generally were allowed only to the person who was, in substance, the owner of the property.

If the property was used in a transaction that was considered a lease for Federal income tax purposes, the lessor was treated as the owner and entitled to ACRS deductions and investment credits. If the property was used in a transaction that was considered a financing arrangement, conditional sale, or similar arrangement, the user of the property was considered the owner for tax purposes. Under section 48(d), in certain circumstances, the lessor of property could elect to pass on the investment credit to the lessee. The determination of whether a transaction was a lease or a conditional sale required a case-by-case analysis of all facts and circumstances.

Although the determination of whether a transaction was a lease was inherently factual, a series of general principles was developed in court cases, revenue rulings, and revenue procedures. Under these general principles, the lessor was required to establish that the property was being used for a business or other income-producing purpose. To establish a business or other income-producing purpose, the lessor had to have a reasonable expectation of deriving a profit from the transaction, independent of tax benefits. *See Hilton* v. *Comm'r*, 74 T.C. 305 (1980), *aff'd*, 671 F.2d 316 99th Cir. (1982). This requirement precluded lease treatment for a transaction that was intended merely to reduce the user's costs by utilizing the lessor's tax base.

The establishment of a business or other income-producing purpose did not automatically result in lease treatment, since a profit motive also exists in a financing arrangement. In addition, the

[13] For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 23; S. Prt. 98-169, Vol. I (April 2, 1984) pp. 864-866; and H.R. Rep. No. 98-861 (June 23, 1984), pp. 801-802 (Conference Report).

lessor had to retain meaningful benefits and burdens of ownership. *See, e.g., Frank Lyon Co.* v. *U.S.* 435 U.S. 561 (1978) *rev'g* 536 F.2d 746 (8th Cir. 1976). Thus, lease treatment was denied if the user of the property had an option to purchase the property at the end of the lease term for a price that was nominal in relation to the value of the property at the time of exercise (as determined at the time the parties entered into the transaction), or for a price that was relatively small when compared with the total payments required to be made. *See* Rev. Rul. 55-540, 1955-2 C.B. 39 (and cases cited therein).

If the residual value to the lessor was nominal, the lessor might have been viewed as having transferred full ownership of the property for the rental fee. If the price under a purchase option was more than nominal but low in comparison to fair market value, the lessor may have been viewed as having transferred full ownership because of the likelihood that the lessee would exercise the bargain purchase option. *See M&W Gear Co* v. *Comm'r*, 446 F.2d 841 (7th Cir. 1971). Further, if the nominal lessor of property had a contractual right to require the nominal lessee to purchase the property (a "put"), the transaction could be denied lease treatment because a put eliminated the risk borne by owners of property that there would be no market for the property at the end of the lease term.

Under the general principles described above, one U.S. Court of Appeals held that a motor vehicle lease containing a terminal rental adjustment clause was, in substance, a conditional sale for Federal income tax purposes. *Swift Dodge* v. *Comm'r*, 696 F.2d 651 (9th cir. 1982), *rev'g.* 76 T.C. 547 (1981).

Effect of TEFRA provision

The Internal Revenue Service took the position that the presence of a terminal rental adjustment clause in a motor vehicle lease caused the transaction to be treated as a conditional sale for tax purposes. Section 210 of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), however, prevented the Internal Revenue Service from denying lease treatment to certain motor vehicle leases entered into before the issuance of regulations by reason of the fact that those leases contained terminal rental adjustment clauses.

Section 210 of TEFRA did not address the legal effect of terminal rental adjustment clauses. Nor did it prevent the issuance of regulations addressing the legal effect of these clauses on a prospective basis. The TEFRA provisions applied only to leases in which the lessee used the property for business, as opposed to personal purposes. The TEFRA provision also was limited to cases where the lessor acquired the property with cash or recourse indebtedness. Thus, the provision did not apply to leases where the lessor financed the property with nonrecourse debt.

In November 1982, the Internal Revenue Service issued proposed regulations providing that nominal leases of motor vehicles would be treated as conditional sales rather than leases if they contained terminal rental adjustment clauses.

Reasons for Change

Leases containing terminal rental adjustment clauses have been widely used by the motor vehicle leasing industry for more than 30 years. These leases were devised for the nontax purpose of providing a financial incentive for the lessee/user, who is the party to the transaction best able to control the maintenance of the vehicle to keep the vehicle in good repair. This objective was achieved by requiring that the lessee bear the cost of any reduction in value of the vehicle resulting from the failure to maintain the vehicle during the lease term. The Congress was of the view that motor vehicle lessors should not be forced to change the way many of them have been doing business. The Congress, however, was unwilling to overrule the principles of the *Swift Dodge* case where the lessee, had it been the owner of the motor vehicle, would generally not have been entitled to any ACRS deductions or investment credits.

Explanation of Provision

Under the Act, a qualified motor vehicle operating agreement containing a terminal rental adjustment clause is to be treated as a lease if, but for that clause, it would be treated as a lease. The provision applies only to qualified agreements with respect to a motor vehicle (including a trailer). No lessee under a qualified agreement can be treated as the tax owner of any property covered by the agreement for any period during which such agreement is in effect (although the lessor is not precluded from passing on the investment credit to the lessee under section 48(d)).

To be a qualified agreement, the nominal lessor must be personally liable for the repayment of all amounts borrowed to finance the acquisition of the motor vehicle involved or must pledge property, other than property subject to the agreement or property directly or indirectly financed by indebtedness secured by property subject to the agreement, as security for all amounts borrowed to finance the acquisition of the motor vehicle involved. In addition, the nominal lessee must certify, in a separate written statement separately signed under penalties of perjury, that it intends that more than 50 percent of the use of the property involved will be in a trade or business of the nominal lessee. That signed certification must also state, clearly and legibly, that the nominal lessee has been advised that it will not be treated as owner of the property for Federal income tax purposes. Furthermore, the nominal lessor must not know that the nominal lessee's certification is inaccurate in any material respect.

The nominal lessor is treated as the tax owner of the property involved under a qualified agreement so long as the agreement, but for the terminal rental adjustment clause, is properly characterized as a lease for tax purposes, regardless of the actual use of the motor vehicle by the nominal lessee. The nominal lessee is not to be treated as the tax owner of the property involved under a qualified agreement even if under the agreement, but for the terminal rental adjustment clause, the nominal lessee would be treated as the tax owner. As a result, the nominal lessee is not entitled to depreciation or interest deductions under the agreement which might be available to it if it were treated as the tax owner of the property (although it may be entitled to an investment credit if the nominal lessor makes an election under section 48(d)). The amount of any deductions allowable to the nominal lessee for rental payments is determined under general Code provisions, including provisions added by the Act.

The term "terminal rental adjustment clause" is defined generally as a provision of an agreement that permits or requires the rental price to be adjusted upward or downward by reference to the amount realized by the lessor under the agreement upon sale or other disposition of the property. Under a special rule, the term also includes a provision that requires a lessee who is a dealer in motor vehicles to purchase the property for a predetermined price and then resell the property, where such a provision achieves substantially the same results as a provision described in the preceding sentence.

No inference was intended that a motor vehicle operating agreement containing a terminal rental adjustment clause is, merely by reason of the presence of that clause, to be treated as a lease for tax purposes. Nor was any inference intended that any nominal lease agreement involving property other than a motor vehicle is to be treated as a lease for tax purposes by reason of a provision similar to a terminal rental adjustment clause.

Effective Date

The provision is effective for agreements entered into more than 90 days after the date of enactment (July 18, 1984). The TEFRA provision is made inapplicable to agreements entered into on or before the 90th day after the date of enactment. The Treasury is not to issue regulations under the TEFRA provision with respect to leases entered into before 90 days after the date of enactment.

Revenue Effect

The provision is estimated to have no effect on fiscal year budget receipts.

C. Treatment of Bonds and Other Debt Instruments

1. Definitions and Technical Amendments (secs. 41-43 of the Act and new secs. 1271, 1272, and 1273 of the Code)[1]

Prior Law

Under prior law (sec. 1232(a)), the retirement of a debt obligation that was issued by a corporation or governmental unit and constituted a capital asset was treated as a sale or exchange.

Normally, a bond is issued at a price approximately equal to the amount for which the bond will be redeemed at maturity, and the return to the holder of the bond is entirely in the form of periodic interest payments. In the case of original issue discount ("OID") bonds, however, the issue price is below the redemption price, and the holder receives some or all of his return in the form of price appreciation. The spread between the issue price and redemption price is the OID. Prior law also provided rules requiring the annual inclusion and deduction of OID.

OID was defined as the difference between the issue price of an obligation and its stated redemption price at maturity. OID was allocated over the term of an obligation through a series of adjustments to the issue price for each "bond period" (defined below). The adjustment to the issue price for each bond period was determined by multiplying the adjusted issue price (*i.e.*, the issue price as increased by adjustments prior to the beginning of the bond period) by the obligation's yield to maturity, and then subtracting the interest payable during the bond period. These rules were found in prior-law sections 1232(b) and 1232A.

Exception for short-term governmental obligations

An exception to the rule requiring annual inclusion was provided for acquisition discount with respect to governmental obligations with a maturity of one year or less. Acquisition discount was defined as the excess of the stated redemption price at maturity over the taxpayer's basis for the obligation. Treasury regulations provided a similar exception for OID with respect to obligations other than governmental obligations held by cash-basis taxpayers.

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[1] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, secs. 41, 42, and 44; H.R. Rep. No. 98-432, Pt. 2 (March 5, 1984); "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, secs. 25, 26, and 28; S. Prt. 98-169, Vol. I (April 2, 1984); House floor amendment, 130 Cong. Rec. H. 2734-2736 (April 11, 1984); Senate floor amendment, 130 Cong. Rec. S. 4433-4436 (April 12, 1984); H.R. Rep. No. 98-861 (June 23, 1984), pp. 802-805 (Conference Report); and H. Con. Res. 328, 130 Cong. Rec. S. 8943 (June 29, 1984), H. 7524 (June 29, 1984).

Definition of "bond period"

Except as otherwise provided by regulations, the accrual period for determining the amount of OID that was allocable to a period was an annual period ending on each anniversary of the date on which the bond was issued. Thus, the yield to maturity of a bond was determined on the basis of annual compounding.

Acquisition premium

When a taxpayer purchased a bond for a price that exceeded the adjusted issue price, the excess (or premium) was allowed as an offset to the remaining OID on a straight-line basis over the remaining term of the bond. Under this rule, the amount of premium allowable as an offset could exceed the OID accrued in some years.

Definition of "purchase"

The term "purchase" was defined to exclude the acquisition of a bond the basis of which is determined by reference to the basis of the bond in the hands of the transferor or under section 1014(a) (relating to property acquired from a decedent).

Definition of "issue price"

The issue price of bonds registered with the Securities and Exchange Commission ("SEC") was defined as the initial price to the public at which a substantial amount of the debt instruments were sold.

Stripped bonds

For purposes of the rules that require the annual inclusion of OID, a stripped bond (*i.e.*, a bond issued with interest coupons where there is a separation in ownership between the bond and any unpaid coupon) or a stripped coupon (any coupon related to a stripped bond) was treated as a bond originally issued by a corporation on the purchase date, and as having OID equal to (i) the stated redemption price at maturity or the amount payable on the due date of such coupon, respectively, over (ii) such bond's or coupon's ratable share of the purchase price (determined by reference to their respective fair market values on the purchase date). These rules were found in prior-law section 1232B.

Reasons for Change

In 1982, the Congress substantially revised the statutory rules that govern the tax treatment of OID. The 1982 legislation presented a number of technical issues that required legislative solutions.

Explanation of Provisions

Under the Act, the rules provided in prior-law sections 1232 (relating to the sale or exchange of debt instruments and to the calculation of OID), 1232A (relating to the current inclusion of OID), and 1232B (relating to stripped bonds or coupons) are now found in sections 1271 (treatment of amounts received on retirement, sale, or exchange of debt instruments), 1272 (current inclusion of OID), 1273 (determination of amount of OID), 1286 (stripped bonds), and

1287 (denial of capital gain treatment for obligations not in registered form). In addition, various technical and clarifying amendments were made to the OID provisions.

Retirement of a debt obligation

The retirement of a debt obligation is treated as a sale or exchange without regard to whether the instrument is a capital asset. This technical amendment has no substantive effect on the characterization of gain realized on sale or exchange of a debt obligation because capital gain treatment is unavailable, in any case, unless the obligation constitutes a capital asset in the hands of the holder.

Short-term obligations

The statutory exception to the periodic inclusion rules for governmental short-term obligations was extended to nongovernmental short-term obligations. This amendment codifies the treatment provided in existing Treasury regulations. Note that another provision of the Act (discussed in item three, below) requires the periodic inclusion of OID or acquisition discount with respect to both governmental and nongovernmental short-term obligations held by certain categories of taxpayers.

Definition of "accrual period"

The term "accrual period" replaces the prior-law references to "bond period." The accrual period with respect to which OID is computed and compounded is defined as each six-month period determined by reference to the maturity date of the bond and the date six months before such maturity date (or the shorter period from the date of issue). Thus, in the case of a bond issued on April 1, 1985, and maturing on January 1, 1987, the first accrual period is April 1, 1985 to June 30, 1985; the second is July 1, 1985 to December 31, 1985; the third is January 1, 1986 to June 30, 1986; and the fourth is July 1, 1986 to December 31, 1986. This treatment corresponds to the prevalent method of calculating yield to maturity in the financial community (based on semiannual compounding).

Acquisition premium

Acquisition premium is amortized by reducing the OID that would otherwise accrue by a constant fraction determined at the time of purchase. The numerator of the fraction is the total amount of premium to be amortized and the denominator is the aggregate amount of unaccrued OID at the time of purchase. Thus, where a bond with a face amount of $100 and an adjusted issue price of $85 is acquired for $90, the numerator of the fraction is $5 and the denominator is $15. The OID that accures during each accrual period is reduced by this fraction. This rule is intended to prevent situations in which the amortization of the acquisition premium exceeds accrual of OID and to provide better matching between the two.

Definition of purchase

The acquisition of a bond from a decedent is treated as a purchase for purposes of the OID provisions, including the rules applicable to stripped bonds and stripped coupons.

Definition of issue price

The issue-price rule applicable to bonds registered with the SEC was extended to all publicly offered issues (other than bonds issued for property). The Act authorizes the issuance of regulations to require the furnishing of the amount of OID, the issue date, and other appropriate information. A penalty of one percent of the issue price is imposed for failures to comply without reasonable cause; the maximum penalty with respect to any one issue of bonds is not to exceed $50,000.

Stripped bonds

A stripped bond or stripped coupon is treated as originally issued on the purchase date: the statutory reference to issuance by a corporation was deleted. The provision that creates OID with respect to stripped bonds applies for all purposes of part V of subchapter P of chapter one of the Code (relating to special rules for bonds and other debt instruments, as added by the Act). Because of opportunities for tax avoidance that may be presented if the exception for short-term obligations were made available to stripped bonds, a technical correction may be necessary to require current inclusion of OID with respect to these instruments.

Effective Date

Except as otherwise provided, the amendments apply to taxable years ending after the date of enactment (July 18, 1984). New Section 1272 does not apply to any obligation that was issued before December 31, 1984, and is not a capital asset in the hands of the taxpayer. For an obligation issued after July 1, 1982, and before January 1, 1985, the accrual period for purposes of section 1272(a) is a one-year period (or shorter period to maturity) beginning on the day in the calendar year that corresponds to the date of original issue of the obligation (the prior-law rule). The new rules for amortizing acquisition premium (sec. 1272(a)(6)) do not apply to any purchase on or before the date of enactment.

None of the relevant amendments affect the application of any effective date provision (including any transitional rule) for any provision that was a predecessor of a provision contained in Part V of Subchapter P of chapter one of the Code (as added by the Act). Thus, for example, any bonds issued pursuant to a written commitment that was binding on July 1, 1982, and at all times thereafter, will be treated as issued on July 1, 1982 (*see* P.L. 97-248, sec. 231).

Revenue Effect

These provisions are estimated to have a negligible effect on fiscal year budget receipts.

2. Market Discount (secs. 41 and 43 of the Act and new secs. 1276, 1277, and 1278 of the Code)[2]

Prior Law

A market discount bond is a bond that is acquired for a price that is less than the principal amount of the bond (or less than the amount of the issue price plus accrued original issue discount (or OID), in the case of an OID bond). Market discount generally arises when the value of a debt obligation declines after issuance (typically, because of an increase in prevailing interest rates or a decline in the credit worthiness of the borrower). Capital gain treatment was accorded to the appreciation in value attributable to market discount on an obligation that was issued by a corporation or governmental unit and held for more than one year. In many cases, interest on indebtedness incurred to purchase or carry a market discount bond was deductible currently against ordinary income, even though some of the income eventually generated by the investment was taxed on a deferred basis at capital gain rates.

Reasons for Change

The Congress recognized that, from the standpoint of the holder of a bond, market discount is indistinguishable from OID. In each case the discount is a substitute for stated interest, and the holder of the obligation receives some of his return in the form of price appreciation when the bond is redeemed at par upon maturity. When a taxpayer makes a leveraged purchase of a market discount bond, the taxpayer effectively converts the ordinary income that is offset by current interest deductions to capital gain that is taxed on a deferred basis and at preferential rates.

The Congress was informed that tax-shelter transactions arose in which taxpayers acquired market discount bonds, using borrowed funds, to take advantage of the opportunities under prior law to defer tax liability on ordinary income and to convert ordinary income to capital gain. The Congress appreciated that the theoretically correct treatment of market discount, which would require current inclusion in the income of the holder over the life of the obligation, would involve administrative complexity. The Congress believed, however, that the prior-law rules should be modified to prevent the use of market discount bonds as a basis for tax-shelter transactions, under an approach that would be more easily administered by taxpayers.

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[2] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, secs. 41, 43, and 44; H.R. Rep. No. 98-432, Pt. 2 (March 5, 1984); Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, secs. 25, 27, and 28; pp. 1170-1173; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 155-159; and H. R. Rep. No. 98-861 (June 23, 1984), pp. 805-807 (Conference Report).

The Congress also believed that it is appropriate to provide tax treatment for market discount on bonds that is more closely comparable to the tax treatment of OID, without regard to whether market discount bonds are held in a tax-shelter context. Capital gain treatment should not be afforded to a largely predictable return (such as that available on the typical purchase of a market discount bond).

Explanation of Provision

Overview

The Act generally requires that gain on disposition of a market discount bond be recognized as interest income, to the extent of accrued market discount (computed under a linear formula). Accrued market discount is not treated as interest for purposes of withholding at source or information reporting requirements under the Code. The Act also limits a taxpayer's ability to take current interest deductions on indebtedness incurred to purchase or carry a market discount bond. The Act provides an election to include accrued market discount in income currently. Neither the rule requiring ordinary income treatment on disposition nor the rule limiting interest deductions applies to bonds with respect to which the election is made.

Accrued market discount treated as ordinary income

In general

Except as otherwise provided by the Act, gain on the disposition of any market discount bond is generally treated as interest income to the extent of accrued market discount, for all purposes of Federal income taxation (including, for example, the statutory provision that limits the deductibility of investment interest). Accrued market discount is not treated as interest for purposes of information reporting or withholding at source required under sections 871(a), 881, 1441, 1442, and 6049 of the Code (or for purposes of such other provisions as the Secretary may specify in regulations). The Act contemplates that accrued market discount will not be treated as fixed or determinable annual or periodical gains, profits, or income subject to withhholding at source. Characterization of the market discount as interest does not affect the issuer of the bond.

For purposes of this rule, a taxpayer who disposes of a bond in a transaction other than a sale, exchange, or involuntary conversion (e.g., by making a gift) is treated as realizing an amount equal to the fair market value of the bond, with the result that accrued market discount is recognized at that time. Under regulations to be prescribed by the Secretary, certain transfers will be excepted from the provisions of the Act. The Act provides that regulations will include rules similar to those of section 1245(b), relating to transfers excepted from the depreciation recapture rules, with certain modifications (including that no exception will be provided for gifts, and that market discount will not be included in income if a bond is transferred in the course of certain tax-free reorganizations). Appropriate adjustments will be made to the basis of any property to reflect gain recognized under the provisions of the Act.

Definition of market discount bond

The Act defines a bond as any bond, debenture, note, certificate, or other evidence of indebtedness. Except as provided by the Act, the term "market discount bond" means any bond having market discount. Exceptions are provided for obligations (i) with a fixed maturity not exceeding one year from date of issue, (ii) the interest on which is not includible in the gross income of the holder under section 103 of the Code (relating to certain governmental obligations), or any other provision of law that provides for tax exemption without regard to the identity of the holder, or (iii) which is a U.S. savings bond.

It is expected that Treasury regulations will provide that the term market discount bond does not include an obligation that was demand debt when issued. Demand debt is insusceptible to treatment under the rules prescribed for computing accrued market discount (which rules are applied by reference to a maturity date).

Definition of market discount

Market discount is generally defined as the excess of the stated redemption price of a bond over the adjusted basis of such bond immediately after its acquisition by the taxpayer. No market discount arises with respect to an installment obligation subject to the rules of section 453B. The purpose of this exception is to prevent the treatment of gain that is deferred under the installment method as market discount (which would otherwise occur because the basis of an installment obligation is equal to the excess of the face value over an amount equal to the income that would be returnable were the obligation satisfied in full). When a market discount bond is exchanged for an installment obligation, however, accrued market discount will be characterized as ordinary income when payments are received pursuant to the rules of section 453. Similarly, if the original holder of an installment obligation transfers the obligation at a discount, the installment obligation will constitute a market discount bond in the hands of the transferee. For OID bonds acquired at a market discount, the stated redemption price is treated as equal to its "revised issue price" (defined as the sum of the issue price of the bond and the aggregate amount of the OID includible in the gross income of all holders for periods before the bond was acquired by the taxpayer). Under a *de minimis* rule, market discount is considered to be zero if the market discount is less than one quarter of one percent of the stated redemption price at maturity, multiplied by the number of complete years to maturity after the taxpayer acquires the bond.

Because market discount is defined generally as any excess of stated redemption price over basis (excluding OID), under a literal interpretation of the statute, market discount is created on issuance of obligations in certain nonrecognition (or nontaxable) exchanges. An example is provided by the application of the statutory definition to bonds issued in exchanges subject to section 351 (which provides nonrecognition treatment where appreciated property is transferred to an 80-percent owned corporation in exchange for stock or securities of the corporation). Under section 358, the basis of a security received in a section 351 exchange is determined by reference to the basis of the transferred property in the hands of the transferor. Thus, assuming no OID, the stated redemption price of the security will exceed its basis immediately after acquisition to the extent of the appreciation of the transferred property. The Congress did not intend to create market discount on the transfer of appreciated property in exchange for a security in a section 351 exchange. Neither did the Congress intend to permit taxpayers to circumvent the market discount provisions by transferring a bond with accrued market discount in a section 351 exchange; in that case it may be appropriate to tax the accrued market discount to the transferor (regardless of whether the transferor receives stock or securities in the exchange).

Linear computation of accrued market discount

Accrued market discount is computed by determining the amount that bears the same ratio to the market discount on the bond as (i) the number of days that the taxpayer held the bond, bears to (ii) the number of days after the date the taxpayer acquired the bond up to (and including) the date of maturity. Thus, the market discount is treated as accruing in equal daily installments during the period the bond is held by the taxpayer.

Accrued market discount on substituted basis property

The following rules apply for purposes of determining the amount of accrued market discount following the transfer of a market discount bond.

Transferred basis property.—With respect to a market discount bond that is "transferred basis property" (property received in a nonrecognition transaction excepted from the Act, the basis of which in the hands of the transferee is determined by reference to its basis in the hands of the transferor), the transferee is treated as having acquired the bond on the date when it was acquired by the transferor for an amount equal to the adjusted basis (increased for gain recognized by the transferor on the transfer). For purposes of this rule, a market discount bond the basis of which is determined under section 732(a), 732(b), or 334(c) is treated as transferred basis property. Thus, for example, a partner who receives a market discount bond in a liquidating distribution from a partnership steps into the shoes of the partnership.

Exchanged basis property.—The amount of accrued market discount with respect to "exchanged basis property" (property received by a taxpayer in a nonrecognition transaction the basis of which is determined in whole or in part by reference to the basis of property that was transferred by the taxpayer in the transaction) includes any accrued market discount to the extent such amount was not previously treated as interest income under the provisions of the Act. For example, on the disposition of stock received upon the conversion of a convertible bond or in a recapitalization in which a bond was exchanged for stock, gain is treated as interest income to the extent of the amount of accrued market discount as of the date of conversion.

Carryover of market discount.—the Act contemplates that, if a bond is received in exchange for a market discount bond pursuant to a plan of reorganization, then the bond so received will be considered to have the same market discount as the bond surrendered. *Cf.* Treas. reg. sec. 1.1232-3(b)(2) (providing a similar rule with respect to OID).

Election to accrue market discount under an economic accrual formula

At the election of the taxpayer, accrued market discount can be computed by using the constant interest method that is provided by present law for the amortization of OID on bonds issued after July 1, 1982. The constant interest method parallels the manner in which interest would accrue through borrowing with interest-paying nondiscount bonds.

Deferral of interest deduction allocable to accrued market discount

Limitation on deduction

The Act limits a taxpayer's ability to take current deductions for interest on indebtedness incurred to purchase or carry a market discount bond. The taxpayer's net direct interest expense is allowed as a deduction only to the extent that the expense exceeds the amount of market discount allocable to the days during the taxable year on which the bond was held by the taxpayer. The term "net direct interest expense" is defined as the excess of the interest paid or accrued by the taxpayer over the interest (including OID) includible in gross income for the taxable year with respect to such bond. In the case of a financial institution to which section 585 or 593 applies, unless the taxpayer otherwise establishes an appropriate allocation, an amount of interest that bears the same ratio to the total interest otherwise allowable as a deduction as the taxpayer's average adjusted basis (within the meaning of section 1016) of market discount bonds bears to the average adjusted basis for all assets of the taxpayer shall be treated as interest paid or accrued on indebtedness incurred to purchase or carry such market discount bonds.

For example, in the case of a financial institution subject to the special rule, the amount of interest otherwise allowable as a deduction would be multiplied by a fraction, the numerator of which is the average basis of all market discount bonds held by the taxpayer and the denominator of which is the average basis of all assets held by the taxpayer. The product, which would be treated as interest paid or accrued on indebtedness incurred to purchase such bonds, would be reduced by any interest includible in gross income with respect to the bonds for the taxable year to obtain the taxpayer's net direct interest expense.

Interest that is deferred under this rule is allowed as a deduction for the taxable year when the taxpayer disposes of the market discount bond. If the bond is disposed of in a transaction in which gain is not recognized in whole or in part, the deferred interest is allowed as a deduction at that time to the extent of recognized gain.

To the extent deferred interest is not allowed as a deduction upon the disposition of a bond in a nonrecognition transaction, the disallowed interest expense will be treated as disallowed interest expense with respect to transferred-basis or exchanged-basis property received in the transaction. Thus, in the case of a market discount bond that is transferred-basis property, the transferee will be entitled to deduct the disallowed interest expense upon disposition of the bond.

For bonds that are subject to the interest-deferral rule but not the rule requiring the recognition of interest income upon disposition of the bond (because the bond was issued before the effective date of the interest-characterization rule), gain on disposition is recognized as interest income to the extent of the disallowed interest expense allowed as an ordinary deduction at the time of disposition. If such a bond is disposed of in a nonrecognition transaction, a similar interest-characterization rule will apply at the time gain is recognized and the disallowed interest expense is allowed as a deduction.

Interest, the deduction for which is deferred as interest on indebtedness incurred or continued to purchase or carry market discount bonds, is not to be taken into account for purposes of computing the disallowance of interest under any other provision that links borrowings to a taxpayer's holdings (*e.g.*, section 265(2), relating to interest on indebtedness incurred or continued to purchase or carry tax-exempt securities).

Short sales

The deduction of short sale expense is deferred where short sales of property are used to generate funds for the purchase of market discount bonds. This rule generally applies in the same manner as the new rule that treats short sale expense as interest for purposes of section 265(2). This rule applies before section 263(g) (which requires taxpayers to capitalize certain otherwise deductible expenses that are allocable to property held as part of a tax straddle).

Election with respect to deferred interest expense

The Act provides an election under which deferred interest expense with respect to a market discount bond can be deducted in a taxable year prior to the year in which such bond is disposed of in cases where, subsequently, there is net interest income from the bond. If the election is made, any deferred interest expense with respect to a market discount bond is treated as paid or accrued to the extent that interest included in gross income exceeds interest that was actually paid or accrued with respect to the bond for a taxable year. Any deferred interest expense that remains after application of the elective provision is deductible on disposition of the market discount bond. The election is made on a bond-by-bond basis.

Election to include accrued market discount in income currently

The Act provides an election to include accrued market discount in gross income for the taxable years to which it is attributable. Under this provision, market discount can be accrued under the economic accrual formula or the linear formula at the election of the taxpayer. If the taxpayer makes an election to include market discount in income currently, neither the rule requiring ordinary income treatment upon disposition nor the interest-deferral rule would apply to bonds acquired during the period the election is in effect. The Act contemplates that where the election is made the taxpayer's basis in the bond will be increased by the amount of market discount included in income with respect to the bond. The election to accrue market discount currently cannot be revoked without the consent of the Secretary.

Effective Date

The provision requiring the recognition of interest income on disposition of a market discount bond applies to obligations issued after the date of enactment of the Act (July 18, 1984). The provision that defers interest deductions on indebtedness incurred to purchase or carry market discount bonds applies to obligations acquired after the date of enactment of the Act.

Revenue Effect

The revenue effects of this provision are included in the estimates of the revenue effects of the provision relating to discount on short-term obligations (see following item).

3. Discount on Short-term Obligations (secs. 41 and 43 of the Act and new secs. 1281, 1282, and 1283 of the Code)[3]

Prior Law

In general, periodic inclusion of original issue discount (OID) was required of the holders of debt obligations. A special rule was provided by statute for governmental obligations that were issued at a discount and payable without interest at a fixed maturity not exceeding one year (Treasury bills). For Treasury bills, discount was not considered to accrue until the obligation was paid at maturity or otherwise disposed of (sec. 454(b)). This rule applied regardless of the character of the obligation in the hands of the holder (*e.g.*, as inventory or a capital asset). Furthermore, on disposition of the instrument, the taxpayer's capital gain or loss was computed with reference to accrual of the acquisition discount, not OID. Under Treasury regulations, there was no current accrual of OID on certain short-term obligations (*e.g.*, certificates of deposit) held by cash-basis taxpayers (Treas. reg. sec. 1.1232-3(b)(1)(iii)).

In many cases, interest on indebtedness incurred to purchase obligations eligible for the special rules could be deducted currently against unrelated income, thereby generating a one-year tax deferral.

Reasons for Change

The special rules that permit deferral of acquisition discount on Treasury bills and original issue discount on short-term discount obligations were commonly used to defer tax liability on ordinary income. For this reason, the Congress concluded that the scope of these rules should be reviewed. The rationale for allowing tax deferral on Treasury bills has been that the tax benefit from a one-year deferral is not large enough to warrant subjecting taxpayers to the additional complexity of accrual accounting. This argument clearly does not apply to taxpayers who use the accrual method of accounting for their other income and deductions for income tax purposes, or for the purpose of reporting to shareholders or creditors. With high interest rates, the balance between simplicity and the tax benefit from a one-year deferral shifted towards greater concern over the revenue loss arising from the tax deferral allowed under prior law. The Congress was also concerned that taxpayers were making leveraged purchases of obligations eligible for the special rules at year-end to achieve tax deferral. The prior-law tax de-

[3] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, secs. 41, 43, and 44; H.R. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1174-1177; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, secs. 25, 27, and 28; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 160-162; and H.R. Rep. No. 98-861 (June 23, 1984), pp. 807-810 (Conference Report).

ferral remains appropriate only for the ordinary investor making unleveraged purchases of Treasury bills or other short-term discount obligations.

Explanation of Provision

Overview

The Act limits the scope of the special rules permitting deferral of acquisition and original issue discount. In addition, the Act limits the ability to use leveraged purchases of short-term discount obligations within the special rules to defer tax on ordinary income. An election is provided under which taxpayers can avoid application of the interest-deferral rule by electing to include discount in income as it accrues.

Mandatory accrual of OID or acquisition discount

The Act requires the current inclusion of OID or acquisition discount with respect to any short-term obligation held (1) by a taxpayer using an accrual method of accounting, (2) primarily for sale to customers in the ordinary course of the taxpayer's trade or business, (3) by a bank (as defined in Section 581) or a common trust fund maintained by a bank, (4) by a regulated investment company ("RIC"), (5) by a partnership, S corporation, trust, or other pass-through entity more than 20 percent of the value of which is owned—for 90 days or more of the entity's taxable year—by taxpayers who are subject to the rule for mandatory accrual, (vi) by any other pass-through entity that is formed or availed of to avoid the application of the rule for mandatory accrual, or (vii) by a taxpayer who identifies the obligation under section 1256(e)(2) as being part of a hedging transaction (generally, a transaction executed in the normal course of a trade or business primarily to reduce certain risks and that results only in ordinary income or loss). If the more-than-20-percent test is satisfied during any 90 day period of a pass-through entity's taxable year, then the rule for mandatory accrual is applied with respect to obligations acquired on or after the first day of the entity's taxable year. The provision that requires current inclusion of OID or acquisition discount with respect to short-term obligations does not change the prior-law treatment of cash-method issuers of such obligations.

Taxpayers using a hybrid method of accounting

The rule for mandatory accrual applies to short-term obligations held by any taxpayer who uses an accrual method of accounting in combination with any other method of accounting.

Optional accrual for RICs

The optional accrual rules for RICs (provided by another provision of the Act) will only apply for taxable years beginning after December 31, 1978, and ending prior to the taxable year that includes the effective date of the rule for mandatory accrual.

Deferral of interest deduction allocable to accrued discount

The Act limits the ability to make leveraged purchases of short-term obligations that are not subject to the rule requiring mandatory accrual. The net direct interest expense with respect to a short-term obligation (as defined for purposes of applying the Act) is allowed as a deduction only to the extent of the daily portions of the acquisition discount for each day on which the taxpayer held the obligation during the taxable year. The term "net direct interest expense" is defined in the same manner as that term is used for purposes of the provision that defers interest deductions allocable to accrued market discount (generally, the excess of interest paid or accrued—determined with regard to the special rule for financial institutions—over interest includible in gross income with respect to the obligation).

For purposes of the interest-deferral rule, rules similar to the rules applicable to market discount bonds will apply (including the allowance of deductions for deferred interest upon disposition of the bond and the treatment of substituted-basis property).

Interest on indebtedness incurred or continued to purchase or carry short-term obligations subject to the interest deferral rule is not taken into account for purposes of computing the disallowance of interest under section 265(2).

Definition of short-term obligation

The Act generally defines "short-term obligation" to mean any bond, debenture, note, certificate, or other evidence of indebtedness that has a fixed maturity date not exceeding one year from the date of issue. An exception is provided for obligations the interest on which is not includible in gross income under section 103 (relating to interest on certain governmental obligations), or any other provision of law that provides for tax-exemption without regard to the identity of the holder.

The Act contemplates that a stripped coupon or a stripped bond will be treated as an evidence of indebtedness within the meaning of the definition of short-term obligation. Thus, because a stripped coupon or stripped bond is treated as originally issued on the purchase date, the mandatory accrual and interest-deferral rules apply to a stripped coupon or stripped bond that is payable not more than one year from the date of purchase (*see also* the discussion in item one, above, regarding the propriety of applying the exception to the current inclusion rule to these instruments).

Definition of acquisition discount

Acquisition discount is defined as the excess of the stated redemption price at maturity (as defined for purposes of the rules requiring the periodic inclusion of OID), over the taxpayer's basis for the obligation.

The Act generally provides that the daily portion of the acquisition discount is equal to (1) the amount of such discount, divided by (2) the number of days after the day on which the taxpayer acquired the obligation and up to (and including) the day of its maturity. The application of this provision results in the linear accrual of the acquisition discount. Under regulations prescribed by the

Secretary, taxpayers may elect to accrue acquisition discount under an economic accrual formula, pursuant to which the daily portion of the discount is computed on the basis of the taxpayer's yield to maturity based on the cost of acquiring the obligation, compounded daily. The election to account for acquisition discount under an economic-accrual formula cannot be revoked without the consent of the Secretary.

Election to include acquisition discount in income currently

The interest-deferral rule does not apply to a taxpayer who elects to include acquisition discount in income currently. If the election is made, the provision for current inclusion will apply to all short-term obligations acquired by the taxpayer on or after the first day of the first taxable year to which the election applies. The election cannot be revoked for subsequent taxable years without the consent of the Secretary.

Short-term obligations other than governmental obligations

The rules described above apply to short-term obligations other than governmental obligations, taking OID into account rather than acquisition discount. Taxpayers who acquire obligations other than governmental obligations can elect to apply these rules with respect to acquisition discount on such obligations rather than OID (regardless of whether the obligation was acquired after original issue). The election, if made, applies to all short-term obligations acquired by the taxpayer after the first day of the first taxable year to which the election applies. This election cannot be revoked without the consent of the Secretary.

The intent of the Congress was to extend the statutory exception to the periodic inclusion requirement to short-term nongovernmental obligations, as provided in existing regulations. The prior statute, as does new section 1271, expressly provides for the treatment of accrued acquisition discount as ordinary income on the sale or exchange of a short-term governmental obligation. The applicable regulations provided for similar treatment on sale or exchange of nongovernmental obligations. Although, the Act is silent on the characterization of accrued OID on sale or exchange of nongovernmental obligations, in light of long-standing judicial authority and the existing regulations, such OID remains taxable as ordinary income. *See* Midland-Ross Corp., 381 U.S. 54 (1965). *See also* Treas. reg. sec. 1.61-7(c) (providing that OID is interest except as otherwise provided by law).

Effective Date

General

The provision relating to the treatment of acquisition and original issue discount is effective for obligations acquired after the date of enactment (July 18, 1984).

Election

The Act provides an election to accrue discount for all short-term obligations held during the taxable year that includes the date of enactment. The election is available only to taxpayers subject to the rule for mandatory accrual of discount on short-term obligations, and only with respect to the taxpayer's first taxable year ending after the date of enactment. If the election is made, the application of the accrual rule is treated as a change in the taxpayer's method of accounting. The net adjustments to income required by section 481 are to be made over a five year period beginning with the year for which the election is made (the "spread period"). The net adjustments will normally be the income that would be included in the taxable year including the date of enactment under cash basis accounting but that is not included under accrual basis accounting.

The amount of the adjustment to be taken into account in the first year of the spread period (the taxable year including the date of enactment) is the sum of (1) one-fifth of the net adjustments, and (2) the excess (if any) of (a) the cash basis income over the accrual basis income over (b) one-fifth of the net adjustments. The term "cash basis income" means the cumulative amount of the acquisition discount or OID with respect to short-term obligations that would be includible in gross income for the current taxable year and the preceding taxable years in the spread period if the rule for mandatory accrual were not applicable. "Accrual basis income" is defined as the cumulative amount of acquisition discount or OID includible in gross income for the current taxable year and the preceding taxable years in the spread period under the rule for mandatory accrual. The requirement that the first year income inclusion be no less than the excess of cash basis over accrual basis income prevents the transition rule from producing a tax reduction relative to prior law (which would arise where the excess of cash basis income over accrual basis income exceeds one fifth of the net adjustments). The five-year spread is intended to mitigate the tax increase provided by the Act, not to provide a tax reduction.

For each year after the first year of the spread period, the amount of the adjustment to be taken into account is the sum of (1) the balance of the net adjustments divided by the number of taxable years remaining in the spread period (including the year for which the determination is being made), and (2) the excess (if any) of (a) the cash basis income over the accrual basis income over (b) one-fifth of the net adjustments, multiplied by five minus the number of years remaining in the spread period (not including the year for which the determination is being made). In computing the excess of cash basis income over accrual basis income for a year subsequent to the first year of the spread period, such excess is reduced by any amount that gave rise to an income inclusion in excess of the amount of the net adjustment allocable to a prior year of the spread period. This formula is also intended to ensure that the five-year spread does not permit taxpayers to receive a tax reduction relative to prior law.

In determining the net adjustments required under section 481 to prevent the omission of amounts, the cash basis income (as defined above) is computed as if such income had accrued in the preceding taxable year and, thereby, resulted in an increase in the basis of the related short-term obligations. Absent this treatment, there would be no omission from income to which section 481 could apply.

Revenue Effect

These changes, and the changes involving market discount bonds, are estimated to increase fiscal year budget receipts by $50 million in fiscal year 1984, $307 million in 1985, $243 million in 1986, $246 million in 1987, $249 million in 1988, and $158 million in 1989.

4. Original Issue Discount on Tax-Exempt Bonds (secs. 41 and 43 of the Act and new sec. 1288 of the Code)[4]

Prior Law

In general, interest on obligations issued by any political subdivision of a State is exempt from Federal income taxation (sec. 103(a)). On the basis of long-standing administrative practice, the Internal Revenue Service ruled that original issue discount (OID) on an obligation issued by a municipality is similarly exempt from tax. (Rev. Rul. 73-112, 1973-1 C.B. 47, restating G.C.M. 10452, X-1 C.B. 18 (1932)). The Internal Revenue Service further ruled that tax-exempt OID is apportioned on a straight-line basis over the term of the obligation among the original holder and subsequent purchasers.

Prior to 1982, holders of OID bonds issued by corporations were also required to apportion OID on a straight-line basis over the term of the obligation. The Tax Equity and Fiscal Responsibility Act of 1982 included a provision that requires the economic accrual of OID on bonds issued by corporations and other entities. The Congress intended that, where appropriate, the 1982 Act also apply for purposes of determining accrual of interest on State and local government bonds.

Reasons for Change

The application of a straight-line interest computation to discount municipal obligations permitted the holder of a deep-discount municipal bond to generate an artificial loss by disposing of the bond prior to maturity. This result could occur because the holder's amount realized on disposition, for purposes of determining gain or loss, was reduced by the amount treated as accrued tax-exempt OID, even though the market price of the bond reflected the (slower) economic accrual of interest.

Recently, there has been a significant increase in the issuance of zero coupon tax-exempt bonds. The Congress was concerned that taxpayers could acquire these obligations to generate tax losses to shelter income. Although The Internal Revenue Service appeared to take the position that that no loss is allowable based on the accrual of tax-exempt OID, some taxpayers claimed that such losses were allowable. The Congress believed that OID on municipal bonds should be accrued in the same manner as that provided for

[4] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, secs. 41 and 44; H.R. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1178-1179; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, secs. 25 and 28; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 163-164; and H.R. Rep. No. 98-861 (June 23, 1984), p. 810 (Conference Report).

OID on obligations issued by corporations and other juridical entities.

Explanation of Provision

The Act requires the holders of discount obligations to accrue tax-exempt OID by using the constant interest method provided by prior law for the holders of obligations issued by corporations and other entities. Under the Act, the basis of an obligation is increased by the amount of accrued tax-exempt OID. Thus, the holder of a zero coupon municipal bond will be entitled to claim economic losses realized on disposition of the bond. The Act also adopts a simplifying assumption for the determination of the issue price of tax-exempt OID bonds. Under this rule, in the case of an issue of bonds sold to the public, the issue price is considered to be the initial offering price to the public (other than bond houses and brokers) at which price a substantial number of the bonds were sold. This rule, which applied under prior law where taxable bonds were sold for cash in a public offering, has the effect of insuring that all bonds in an issue have a single issue price.

In the case of tax-exempt obligations with a maturity of less than one year, interest will be computed in a manner similar to the rules for short-term taxable obligations (*i.e.*, compounded daily). This rule is applied with respect to original issue discount, which is the amount of discount that inured to the benefit of the governmental unit, not acquisition discount.

Effective Date

This provision is effective for obligations issued after September 3, 1982 (the date of enactment of the Tax Equity and Fiscal Responsibility Act) and acquired after March 1, 1984.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $3 million in 1984, $5 million in 1985, $7 million in 1986, $8 million in 1987, $10 million in 1988, and $13 million in 1989.

5. Timing and Measurement of Interest Income and Deductions in Deferred Payment Transactions (secs. 41 and 44 of the Act and secs. 163(e) and 483 and new secs. 1272, 1273, 1274, 1275, and 6706 of the Code)[5]

Prior Law

Timing of inclusion and deduction of interest: the OID rules

If, in a lending transaction, the borrower receives less than the amount to be repaid at the loan's maturity, the difference represents "discount." Discount performs the same function as stated interest; that is, it compensates the lender for the use of its money.[6] Sections 1232A and 163(e) of prior law (the "OID rules") generally required the holder of a discount debt obligation to include in income annually a portion of the original issue discount on the obligation, and allowed the issuer to deduct a corresponding amount, irrespective of whether the cash method or the accrual method of accounting was used.[7]

Original issue discount was defined as the excess of an obligation's stated redemption price at maturity over its issue price. This amount was allocated over the life of the obligation through a series of adjustments to the issue price for each "bond period" (generally, each one-year period beginning on the issue date of the bond and each anniversary). The adjustment to the issue price for each bond period was determined by multiplying the "adjusted issue price" (the issue price increased by adjustments prior to the beginning of the bond period) by the obligation's yield to maturity, and then subtracting the interest payable during the bond period. The adjustment to the issue price for any bond period was the amount of OID allocated to that bond period.

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[5] For legislative background of the provision, *see*: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, secs. 41 and 44; H.R. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1241-1251; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, secs. 25 and 28; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 249-259; House floor amendment, 130 Cong. Rec. H. 2734-2736 (April 11, 1984); Senate floor amendment, 130 Cong. Rec. S. 4434 (April 12, 1984); H.R. Rep. No. 98-861 (June 23, 1984), pp. 885-889 (Conference Report); and H. Con. Res. 328, 130 Cong. Rec. S. 8881, 8943 (June 29, 1984), H. 7524 (June 29, 1984).

[6] *United States* v. *Midland-Ross Corp.*, 381 U.S. 54 (1965) (a case decided under the 1939 Code). *See also Commissioner* v. *National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134 (1974).

[7] The premise of the OID rules was that an OID obligation should be treated in the same manner as a nondiscount obligation requiring current payments of interest for tax purposes. To accomplish this result, the rules in essence treated the borrower as having paid the lender the annual unpaid interest accruing on the outstanding principal balance of the loan, which amount the borrower was allowed to deduct as interest expense and the lender was required to include in income. The lender was then deemed to have lent this amount back to the borrower, who in subsequent periods was deemed to pay interest on this amount as well as on the principal balance. This concept of accruing interest on unpaid interest is commonly referred to as the "economic accrual" of interest, or interest "compounding."

The OID rules did not apply to obligations issued by individuals,[8] obligations with a maturity of one year or less, or obligations issued in exchange for property where neither the obligation nor the property received for it was traded on an established securities exchange.

Measurement of interest in deferred-payment transactions involving property: the imputed interest rules

A deferred-payment sale of property exempt from the OID rules was generally subject to the unstated interest rules of section 483.[9] If the parties to the transaction failed to state a minimum "safe-harbor" rate of interest to be paid on the loan by the purchaser-borrower, section 483 recharacterized a portion of the principal amount as unstated interest. This "imputation" of interest was performed by assuming that interest accrued at a rate higher than the safe-harbor rate.

The safe-harbor rate was a simple interest rate; the imputation rate was a compound rate. The safe-harbor and imputation rates were 9 percent and 10 percent, respectively, when the Act became law. The safe-harbor interest rate applicable to certain transfers of land between members of the same family was 6 percent.

Section 483 provided exceptions (1) for transactions where the sales price did not exceed $3,000; (2) for payments made pursuant to a transfer described in section 1235(a) (relating to the sale or exchange of patents); (3) in the case of sellers, for sales of property if all of the gain on the sale would have been ordinary; and (4) for amounts constituting an annuity under section 72, the liability for which depended on life expectancy.

If interest was imputed under section 483, a portion of each deferred payment was treated as unstated interest. The allocation between unstated interest and principal was made on the basis of the size of the deferred payment in relation to the total deferred payments. Amounts characterized as unstated interest were included in the income of the lender in the year the deferred payment was received (in the case of a cash method taxpayer) or due (in the case of an accrual method taxpayer). The borrower correspondingly deducted the imputed interest in the year the payment was made or due.

Section 482

Section 482 authorizes the Commissioner of Internal Revenue to allocate income and deductions between commonly controlled organizations, trades, or businesses, where necessary to prevent evasion of taxes or to clearly reflect income. The regulations under section 482 provide "safe-haven" minimum and maximum interest rates in the case of certain loans and credit sales between commonly controlled businesses.

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[8]Prior to 1982, the OID provisions applied only to corporate and taxable government obligations. The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) extended these provisions to noncorporate obligations other than those of individuals.

[9]Under Treas. Reg. secs. 1.483-1(b)(3) and 1.483-1(d)(3)(ii), section 483 does not apply to a transaction subject to the OID rules.

Reasons for Change

Mismatching and noneconomic accrual of interest

Enacted in 1969, the OID rules were designed to eliminate the distortions caused by the mismatching of income and deductions by lenders and borrowers in discount lending transactions. Prior to that time, an accrual method borrower could deduct deferred interest payable to a cash method lender prior to the period in which the lender included the interest in income.[10] Although the OID rules prevented mismatching in many situations, the potential for distortion continued to exist where the obligation was excepted from the OID rules. Some taxpayers attempted to exploit these exceptions, particularly the exception relating to nontraded obligations issued for nontraded property,[11] to achieve deferral of tax on interest income and accelerated deductions of interest expense.

For example, in a typical transaction, real estate, machinery, or other depreciable property was purchased for a promissory note providing that interest accrued annually but was not payable until the note matured. The issuer, who used the accrual method of accounting, would claim annual interest deductions for accrued but unpaid interest. The holder, a cash method taxpayer, would defer interest income until it was actually received.

Such a mismatching of income and deductions had serious revenue consequences, since the present value of the income included by the lender in the later period was less than the present value of the deductions claimed by the borrower.[12] The greater the length of time between the borrower's deduction and the lender's inclusion, the greater the loss of tax revenues.

This revenue loss was magnified if the accrual-method purchaser computed its interest deduction using a noneconomic formula such as straight-line amortization, simple interest, or the "Rule of 78's".[13] In Rev. Rul. 83-84, 1983-1 C.B. 9, the Internal Revenue

[10] In enacting the OID rules, Congress assumed that most issuers of discount bonds were deducting a portion of the discount annually, while the holders (many of whom were cash-method individuals) were including the discount in income only upon disposition of the bond, if at all. If the discount was taxable only at the time of disposition, the holder was more likely to ignore that the discount was taxable and that it was ordinary income rather than capital gain. Congress believed that by requiring the bondholders to report discount income on an accrual basis, better compliance would be achieved. *See* H.R. Rep. No. 91-413 (Part 1), 91st Cong., 1st Sess. 109 (1969); S. Rep. No. 91-552, 91st Cong., 1st Sess. 146-147.

[11] The bill that became the Tax Reform Act of 1969, as reported by the Senate Finance Committee and the House Ways and Means Committee, included within its scope essentially all transactions involving issuance of a debt obligation for property. A Senate floor amendment added the exception for obligations issued for nontraded property, reflecting concern that the parties to such sales might take inconsistent positions on valuation to the detriment of the Treasury. *See* letter from John S. Nolan, Deputy Assistant Secretary of the Treasury, to Sen. John J. Williams, dated November 28, 1969, 115 Cong. Rec. 36730-36731 (1969).

[12] The Conference Report to the Technical Corrections Act of 1982, which repealed the exception to section 1232 for publicly traded obligations issued in a reorganization, had specifically referred to the mismatching problem in transactions involving nontraded debt and property, and indicated that further legislation might be appropriate in the near future if the Treasury Department was unable to deal with the problem administratively. H.R. Rep. No. 97-986, 97th Cong., 2d Sess. 21 (1982). While it was possible that the Internal Revenue Service could successfully challenge the deductions for accruing interest under various theories, this result was unclear. *See* Canellos and Kleinbard, "The Miracle of Compound Interest," 38 Tax L. Rev. 565, 606-609 (1983).

[13] The Rule of 78's is a formula for allocating interest over the term of a loan that results in larger deductions in the early years. To illustrate, in the case of a thirty-year loan, interest would be calculated under the Rule of 78's by first taking the sum of the integers from 1 through 30 ($1+2+3+4$ . . . and so on up to 30), or 465. The borrower would accrue 30/465 (or

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Service stated that interest may be deducted only to the extent it has accrued economically, using a constant yield-to-maturity formula. Some taxpayers, however, took the position that the ruling incorrectly interpreted existing law. Other taxpayers construed the ruling narrowly, as applying only to the precise facts set forth in the ruling.

In light of the significant distortions occurring under prior law, both in the form of mismatching of interest income and deductions and in the form of noneconomic accruals of interest, Congress believed it appropriate to extend the periodic inclusion and deduction rules of sections 1232A and 163(e) of prior law to nontraded debt instruments issued for nontraded property. The same policy objectives that led to the application of these rules to interest on traded debt instruments or instruments issued for cash—namely, better compliance by holders and clearer reflection of income—were believed to apply equally in the case of nontraded instruments issued for nontraded property.

The principal obstacle to applying the OID rules to a transaction in which neither side is traded is the difficulty of determining the issue price of the debt instrument directly. Both the issue price and the redemption price of an instrument must be known to compute the amount of OID. In a transaction involving the issuance of an note for cash, the issue price is simply the amount of cash received. Where the issuer receives nontraded property, however, the fair market value of the property determines the obligation's issue price.[14] Using a "facts and circumstances," case-by-case analysis to determine fair market value in these situations was considered impracticable. Congress believed that the valuation problem could best be resolved by incorporating into the OID rules a mechanism for testing the adequacy of interest in a sale of property already present in the Code—the unstated interest rules of section 483—with certain modifications. An approximation of the maximum fair market value of property (and hence the issue price of the obligation issued in exchange for it) could be arrived at by assuming a minimum rate of interest which parties dealing at arm's-length and without tax motivations could be expected to agree upon.

Since individuals frequently issue debt obligations in exchange for property, and these obligations often provide for deferred payments of interest, Congress believed it necessary to eliminate the exception to the OID rules for obligations issued by individuals.

Finally, Congress believed there was no justification for continuing the exemption from the OID rules for holders of obligations not constituting capital assets in the holder's hands. Sales of ordinary income assets may involve deferred interest to the same degree as sales of capital assets, and the timing of income in such sales is as important as its character.

While acknowledging the complexity of the OID rules, Congress believed that the rules could be extended to a broader range of transactions without disrupting the routine, legitimate transactions

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6.45 percent) of the total interest in the first year, 29/645 (6.24 percent) in the second year, and so on until the 30th year, when 1/465 (.22 percent) of the total interest would be accrued.

[14] The issue price of the obligation in such a transaction is the value of the property received by the issuer, less any cash down payment made to the holder.

of individuals or small businesses, which might have difficulty applying the rules. The Act exempts many such routine transactions.

Mismeasurement of interest in transactions involving nontraded property

Congress recognized that, under prior law, it was possible for taxpayers in a sale of nontraded property for nontraded debt to achieve unwarranted tax benefits not only by mismatching interest income and deductions, but by manipulating the principal amount of the debt. This could be accomplished by artificially fixing interest at a below-market rate. Although economically the parties were in the same position as if interest had been accurately stated, significant tax advantages often resulted from characterizing the transaction as involving a lower rate of interest and a larger loan principal amount. If recognized for tax purposes, this mischaracterization of interest as principal resulted in an overstatement of the sales price and tax basis of the property.[15] In cases where the property was a capital asset in the hands of the seller, the seller was able to convert interest income, which should have been taxable as ordinary income in the year it accrued, into capital gain taxable at lower rates (and, under the installment method provided in sec. 453, generally only as installment payments were made). If the property was depreciable in the hands of the purchaser, the inflated basis enabled the purchaser to claim excessive cost recovery (ACRS) deductions and, if the property constituted section 38 property, investment tax credits.

These same tax advantages accrued to taxpayers who engaged in low-interest transactions entirely for nontax reasons.

Inadequacy of test and imputation rates.—Section 483 of prior law failed to control this overstatement of purchase price and tax basis, whether intentional or unintentional, because both the test rate and the imputation rate were frequently less than prevailing market rates. The section 483 rates were inadequate for three reasons. First, although the rates were changed periodically, they failed to keep pace with market interest rates. Second, the simple interest computation used in testing the adequacy of stated interest ignored the compounding of interest on unpaid interest which occurs as an economic matter.[16] Finally, the use of a single rate for all obligations regardless of maturity failed to reflect the fact that lenders typically demand different returns on investment depending on the term of the loan.

Congress believed that the solution was to provide a mechanism for bringing the test and imputation rates closer to market rates and for keeping the rates more current.

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[15]To illustrate, assume a sale of equipment which Seller and Buyer agree is worth $100 in cash, and a market interest rate of 12 percent (compound interest). Buyer agrees to pay, and Seller agrees to accept, a lump sum amount of $176 at the end of five years. From an economic perspective, the $176 lump sum payment is comprised of $100 principal and $76 interest. Under prior law, however, the transaction could be structured as a sale for a $121 note bearing simple interest at 9 percent ($121 grows to approximately $176 in five years at a rate of 9 percent simple interest).

[16]For example, a debt obligation maturing in 30 years bearing a stated rate of 9-percent simple interest, all payable at maturity, actually bears interest at a rate of approximately 4-1/2 percent on a compound interest basis.

Allocation of payments between principal and interest.—A further problem with section 483 under prior law was its method of allocating unstated interest among deferred payments. Some tax shelters were exploiting this method of allocation to accelerate several years' interest charges into the year of the sale.

To illustrate, assume property with an established fair market value of $100,000 is sold for $2,500 in cash and two negotiable $100,000 notes, one maturing six months and one day after the sale (payments on an obligation are within the scope of section 483 only if they are due more than six months after the sale), the other thirty years after the sale. The present value of the cash and notes, assuming a 12 percent interest rate, would approximately equal the $100,000 value of the property. Since the notes have no stated interest, section 483 of prior law imputed interest at a rate of 10 percent, compounded semiannually. Applying this rate, the total unstated interest in the deferred purchase contract would be $99,408 (the $200,000 aggregate face value of the notes less $100,592, the sum of their present values).

Since the deferred payments in this example are to be made in two equal installments, the total unstated interest of $99,408 would be allocated (under prior section 483) one-half ($49,704) to the first note and one-half to the second. Thus, the purchaser arguably would be entitled to deduct as interest almost one-half the cost of the property in the year of purchase when, economically, virtually all of the imputed interest actually would be paid in the second payment.[17]

Congress believed that the allocation of unstated interest among the payments on a loan not subject to constant interest accrual under the OID rules should be made in a manner consistent with the principles set forth in Rev. Rul. 83-84.

Adequacy of interest under section 482

The safe-haven interest rates under the section 482 regulations suffered from the same deficiencies as the rates under section 483. Congress believed that the interest rates for credit transactions involving nontraded property within the scope of section 482 should be determined in a manner consistent with the determination of the rates under sections 1274 and 483.

Explanation of Provisions

a. Extension of OID rules

Overview

The Act extends the rules for periodic inclusion and deduction of original issue discount by lenders and borrowers to debt instruments that are issued for property that is not publicly traded, and that are themselves not publicly traded. The Act also repeals the exemption for obligations issued by individuals and the exemption

[17] Although the rules restricting deductions for prepaid interest might apply to limit the amount of the interest deduction in this situation, this result is not clear. Moreover, although the section 483 rules otherwise would require the seller to recognize the same $49,704 as ordinary income in the year of payment, the seller arguably could have avoided this result by disposing of the first note within six months of the sale.

from the income accrual requirement for cash-method holders of obligations not constituting capital assets in the holder's hands.[18] Exceptions from the rules are provided to ensure that they will not apply to most routine transactions of individual taxpayers, or to *de minimis* transactions of individuals and others.

If either the debt instrument or the property for which it is exchanged is publicly traded, the amount of OID is determined as under prior law. The market value of the traded side determines the issue price of the obligation, and the excess of the redemption price over the issue price is original issue discount. Where neither side is traded, the transaction is tested for the adequacy of stated interest in a manner similar to that prescribed in section 483 of prior law.[19]

If the stated rate of interest is not equal to or greater than a safe-harbor rate, the issue price is determined by imputing interest to the transaction at a higher rate. The safe-harbor rate and the imputation rate are equal to specified percentages of the "applicable Federal rate," a rate based on the yields of marketable securities of the United States government. The safe-harbor rate is 110 percent of the applicable Federal rate, and the imputation rate is 120 percent of that rate.

Transactions to which section 1274 applies

In general, new section 1274 of the Code applies to a debt instrument if (1) neither the instrument nor the property received in exchange for the instrument is publicly traded, (2) some or all of the payments under the instrument are due more than six months after the sale, and (3) the stated redemption price at maturity of the instrument exceeds its stated principal amount (if there is adequate stated interest) or its "imputed principal amount" (if there is inadequate stated interest). A debt instrument includes any obligation to pay, whether or not evidenced by a formal instrument.

Section 1274 as added by the Act performs two distinct roles. First, it serves the function of section 483 of prior law[20] by testing the adequacy of stated interest in a transaction and, where stated interest is inadequate, imputing interest. Second, it places the parties to a transaction involving nontraded debt and property on the accrual method of accounting as to any interest (whether stated or imputed) not paid currently. It accomplishes this by bringing within the OID rules (which are restated, with some modifications,[21] in new Code sections 1272 and 1273) most transactions involving either inadequately stated interest or adequately stated interest not paid currently.[22]

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[18]*See also* sec. 128 of the Act, amending Code secs. 871 and 881. This provision generally extends the OID and coupon-stripping provisions to foreign investors unless the U.S. borrower is related to the foreign lender.

[19]Congress did not intend that the imputed interest rules apply to foreign currency loans or other transactions where the value of the property received for the obligation is readily ascertainable by reason of active trading in an established market. A technical correction may be necessary to prevent the application of these rules to such transactions.

[20]As discussed below, the Act retains a modified version of section 483, which tests the adequacy interest in transactions not subject to section 1274.

[21]For further discussion of the modifications to the general OID rules, see below.

[22]The practical effect of the Act is thus to apply the OID rules to all transactions except those in which the potential for the abuses perceived by Congress is absent, namely, those in which (1)

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Thus, the OID rules now apply to any transaction involving nontraded debt and nontraded property unless the debt instrument bears interest at a rate at least equal to 110 percent of the applicable Federal rate, and such interest is unconditionally payable at the stated rate on a semiannual basis (or is payable at the equivalent annual, quarterly, or monthly rate).[23] If an instrument provides for interest payable semiannually at a rate equal to 110 percent of the applicable Federal rate, but interest accrues at a higher rate (based on a fixed rate of compound interest), section 1274 applies and, in conjunction with sections 1272 and 1273, deems the instrument to contain OID equal to the difference between the amount of interest paid currently and the amount of interest accrued. A portion of this OID is reported as income by the lender and deducted by the borrower on a current basis.

Determination of issue price and amount of OID

The issue price of an obligation is the stated principal amount unless there is inadequate stated interest. The adequacy of the interest element in a transaction is determined by comparing the debt instrument's stated principal amount to the "testing amount"—the amount determined by discounting, at a rate equal to 110 percent of the applicable Federal rate, all payments due under the instrument).) An instrument contains adequate stated interest if the stated principal amount is less than the testing amount.[24]

If a debt instrument does not contain adequate stated interest, section 1274 deems the principal amount (and the issue price) of the instrument to be the "imputed principal amount." The imputed principal amount is the amount determined by discounting all payments due under the instrument using a discount rate equal to 120 percent of the applicable Federal rate, compounded semiannually.

Section 1273, which replaces section 1232(b)(1) of prior law, provides that the amount of original issue discount is the difference between the issue price of an instrument and its stated redemption price at maturity. Although the issue price of an instrument issued for nontraded property for purposes of section 1273 is generally either the stated principal amount or the imputed principal amount, in certain "potentially abusive situations" neither of these amounts may determine the issue price, as discussed below.

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the principal amount of the loan (and hence the purchase price and tax basis of the property) has not been overstated, and (2) there is no mismatching of interest income and deductions by the parties.

[23] *See* Rev. Rul. 84-163, 1984-47 I.R.B. 25, 27, Tables 1 and 2.

[24] The rationale for this methodology can be summarized as follows. Congress believed that 110 percent of the applicable Federal rate was a reasonable approximation of the rate at which a good credit risk with adequate security could borrow. (For simplicity, the Act generally assumes that all taxpayers could borrow at this conservative rate.) Discounting all payments under the instrument at this rate should, therefore, provide a liberal (high) estimate of the principal amount of the loan (and, hence, of the true purchase price of the property) involved in a transaction. This is true because, given a fixed stream of payments—for example, the schedule of principal and interest payments due under a mortgage note—the present value of the payments (loan principal amount) varies inversely with the discount (interest) rate. If the stated principal amount is greater than the testing amount, the interest rate implicit in the transaction is necessarily less than the safe-harbor rate, and the parties have converted some interest into purchase price.

Applicable Federal rate

The applicable Federal rate for an obligation is a rate based on the average yield for marketable obligations of the United States government with a comparable maturity. Federal rates are periodically computed and published by the Treasury Department. The rates are redetermined at six-month intervals for three categories of obligations: short-term maturity (three years or less); mid-term maturity (more than three years but not in excess of nine years); and long-term maturity (more than nine years). The applicable Federal rate for a transaction is the rate in effect for that category of maturity on the first day there is a binding contract for the sale or exchange.[25] Federal debt obligations with characteristics that result in a yield substantially above or below a market rate of interest are disregarded in computing the applicable Federal rates. Thus, for example, the yield on bonds, the face amount of which may be used to satisfy Federal estate tax obligations (so-called "flower bonds"), is not taken into account. Furthermore, Congress expected that in computing the Federal rates, the Treasury Department will make appropriate adjustments to reflect the tax exemption for interest on an obligation.[26]

Examples

Example 1

The following example illustrates the application of section 1274, in conjunction with sections 1272 and 1273, where a debt instrument states adequate interest but does not require current payment of all interest.

On January 1, 1985, Seller and Buyer enter into a contract for the sale of an office building to Buyer on the following terms: $1 million cash payable at closing; $10 million nonrecourse "balloon" Note bearing 16-percent simple interest, due in five years; interest payable annually at a rate of 12 percent; accrued but unpaid interest payable at maturity of the Note.

(1) Determination of issue price

The issue price of the Note is the stated principal amount ($10 million) unless there is inadequate stated interest. There is inadequate stated interest if the stated principal amount exceeds the testing amount. The testing amount is $10,487,364, the present value of all payments due under the Note[27] using a discount rate

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[25]Although the Act does not specify Federal rates for transactions involving binding contracts entered into after February 29, 1984, and closed after December 31, 1984 (which are not "grandfathered" by the Act), the Internal Revenue Service has published rates applicable to these transactions. Rev. Rul. 84-163, 1984-47 I.R.B. 25.

[26]*See* Code sec. 1288 as added by the Act. Congress intended that similar adjustments be made in cases where the interest rate is subsidized by the Federal Government or a State or local government, and in cases involving loans described in Code section 133. Section 133 provides an exclusion from gross income of 50 percent of the interest income on certain "securities acquisition loans" involving employee stock ownership plans.

[27]That is, the present value on January 1, 1985, of $1,200,000 due at the end of 1985, $1,200,000 due at the end of 1986, $1,200,000 due at the end of 1987, $1,200,000 due at the end of 1988, and $13,200,000 due at the end of 1989. The $13,200,000 payment in 1989 represents simple interest at 12 percent on the stated principal of $10,000,000, plus accrued but unpaid simple interest at 4 percent for five years, plus $10,000,000 stated principal.

of 13.64 percent. This discount rate is a "blend" of the 9.2 percent annual rate (the equivalent of 9 percent compounded semiannually) applicable to the first $2 million of stated principal amount (see discussion of transitional rules, below) and the 14.75 percent rate applicable to the remaining $8 million. The 14.75 percent rate is 110 percent of the applicable Federal rate (AFR), based on annual payments of interest. Rev. Rul. 84-163, 1984-47 I.R.B. at 27, Table 1.[28]

Since the stated principal amount ($10 million) does not exceed that the testing amount ($10,160,171), the Note contains adequate stated interest. Accordingly, the stated principal amount is the issue price for purposes of determining the amount of OID.

(2) Determination of stated redemption price at maturity

The stated redemption price at maturity is the amount payable at the maturity of the loan as fixed by the last modification of the agreement. It includes interest and other amounts payable at maturity other than any interest based on a fixed rate, and payable unconditionally at fixed periodic intervals of one year or less during the entire term of the debt instrument.

The stated redemption price in this example is $12,000,000, that is, the $13,200,000 due on December 31, 1989, minus $1,200,000 (interest payable annually at a fixed rate of 12 percent and hence excluded from the redemption price).

(3) Determination of amount of OID

The amount of OID is the excess of the stated redemption price at maturity ($12,000,000) over the issue price ($10,000,000), or $2,000,000.

(4) Reporting of OID

A portion of the $2,000,000 of OID will be annually reported as interest income by Seller and deducted as interest expense by Buyer under the general OID rules (secs. 1272 and 163(e)), in essentially the same manner as under prior law. Thus, in 1985, Seller will include and Buyer will deduct the sum of the daily portions for the year, computed under section 1272.[29]

Example 2

The following example illustrates the application of section 1274 in a situation where all interest is paid currently, but inadequate interest is stated.

Assume the same facts as in Example 1, except that the Note bears 12 percent simple interest, payable currently.

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[28] *See* sec. 44(b)(4) of the Act, as amended by H.R. 5361 (P.L. 98-612, October 31, 1984). The blended rate is determined under the statutory formula as follows:

9.0% + [(110% AFR−9.2%) x [(borrowed amount −$2,000,000) divided by (borrowed amount)] = 9.2% + [(14.75%−9.2%) x [($10,000,000−$2,000,000)/($10,000,000)] = 9.2% + [(5.55%) x ($8,000,000/$10,000,000)] = 9.2% + [5.55% x .8] = 13.64%.

[29] The annual amounts of OID would be as follows: $296,818 in 1985, $341,246 in 1986, $392,325 in 1987, $451,049 in 1988, and $518,562 in 1989.

(1) Determination of issue price

The testing amount is $9,432,069.[30] Because the stated principal amount ($10 million) exceeds the testing amount, the issue price of the Note is the imputed principal amount. The imputed principal amount is $9,006,198, the present value of all payments due under the Note assuming a discount rate equal to a blend of 10 percent (compounded semiannually) and 120 percent of the Federal mid-term rate.[31]

(2) Determination of stated redemption price at maturity

The Note's stated redemption price is $10 million, the $11,200,000 due on December 31, 1989, minus the $1,200,000 representing interest payable annually at a fixed rate of 12 percent.

(3) Determination of amount of OID

The total amount of OID is the excess of the stated redemption price ($10 million) over the issue price ($9,006,198), or $993,802.

(4) Reporting of OID

Seller and Buyer will report the aggregate daily portions of the OID in each year of the Note's term under the general OID rules (secs. 1272 and 163(e)).[32]

Limitation on principal amount of a debt instrument

The principal amount of a debt instrument as determined under section 1274 has collateral consequences under other Code sections. It indirectly determines the amount realized by the seller on a sale of property (sec. 1001(b)), and hence the amount of its gain or loss. The principal amount also determines the amount the buyer pays for property, which is generally its basis in the property (sec. 1012).

The Act provides that, in a "potentially abusive situation," the principal amount of any note may not exceed the fair market value of the property sold.[33] This limitation applies whether the stated interest is adequate or inadequate under section 1274. Conversely, the principal amount of an instrument plus any cash down payment may not be less than the fair market value of the property in such situations.[34]

A potentially abusive situation includes any transaction involving a "tax shelter" as defined in section 6661(b)(2)(C). It also includes any other situation that, because of (1) recent sales transactions, (2) nonrecourse financing, (3) financing with a term beyond the economic life of the property, or (4) other circumstances, is of a

[30] This is the present value on January 1, 1985, of the total payments due under the Note. The computations are the same as in Example 1, except that the total payments in 1989 are $11,200,000 rather than $13,200,000.

[31] The annual equivalent of 10 percent, compounded semiannually, is 10.25 percent; the annual equivalent of 120 percent of the AFR, compounded semiannually, is 16.14 percent.

[32] The annual amounts of OID would be as follows: $147,507 in 1985, $169,577 in 1986, $194,949 in 1987, $224,118 in 1988, and $257,650 in 1989.

[33] This ceiling is reduced to the extent of the buyer's cash down payment and the value of any traded property involved in the transaction.

[34] The purpose of the latter restriction is to prevent the intentional overstatement of OID. A taxpayer might be motivated to overstate the interest element of a sale, for example, if the property involved in the sale were nondepreciable or the seller were not subject to U.S. tax on interest income.

type which the Secretary by regulations identifies as having a potential for abuse.

For example, if a taxpayer buys property for cash and, six months later, sells the property for a note with a face amount significantly greater than the cash price paid earlier, a potentially abusive situation exists. Unless the seller substantially improved the property or the higher purchase price can otherwise be justified, the principal amount of the loan would be limited to the fair market value of the property.

The limitations on principal amount imposed by these provisions do not override prior case law dealing with overstatement of basis and other abuses in transactions involving nonrecourse debt. As under prior law, an obligation must represent a bona fide indebtedness of the purchaser-issuer to be respected for purposes of the OID rules and other provisions of the Code. Thus, if a nonrecourse obligation is given in exchange for property having a value less than the principal amount of the purported debt obligation (determined in accordance with these new provisions), the obligation may be disregarded in whole or in part under general principles of tax law and basis, interest deductions, and other tax benefits may be denied. *See, e.g., Estate of Franklin* v. *Commissioner*, 544 F.2d 1045 (9th Cir. 1976); *Odend'hal* v. *Commissioner*, 80 T.C. 588 (1983); Rev. Rul. 78-29, 1978-1 C.B. 62; and Rev. Rul. 82-224, 1982-2 C.B. 5.[35]

Moreover, Congress intended that an issuer of a nonrecourse obligation be permitted to deduct original issue discount only to the extent that, at the time a deduction would otherwise be allowed, the value of the property equals or exceeds the sum of the principal balance and the previously amortized original issue discount.

In cases where the principal amount of an obligation is reduced pursuant to the fair market value limitation described above, the principal amount in excess of the fair market value of the property may be treated as contingent purchase price with respect to the property, thus giving rise to additional tax basis to the purchaser if and when such amount is paid to the seller.

Exceptions

The Act provides exceptions to section 1274 for the following:

Farms.—Section 1274 does not apply to debt instruments received by an individual, estate, or testamentary trust, by a small business corporation (as defined in section 1244(c)(3), relating to losses on small business stock), or by a partnership whose capital is not in excess of the limits specified in section 1244(c)(3),[36] in exchange for a farm. This exception applies only if it can be determined at the time of sale that the sales price cannot exceed $1 million.

This exception is subject to an aggregation provision designed to prevent taxpayers from avoiding the $1 million limitation by dividing what is in substance a single transaction into two or more

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[35] A purported sale may be merely a grant of an option rather than a sale or exchange within the meaning of section 1274. *See* Treas. Reg. sec. 1.83-3(a)(2) (purchase of property subject to nonrecourse debt in employment or compensation context may be viewed as grant of an option, and hence not transfer of underlying property).

[36] The determination of whether an entity meets the conditions of section 1244(c)(3) is made at the time of issuance of the obligation in question.

smaller transactions. Sales and exchanges that are part of the same transaction or a series of related transactions are treated as one sale or exchange.[37]

Principal residences.—Debt instruments received by an individual as consideration for the sale or exchange of a principal residence (as defined in sec. 1034) are not subject to section 1274, regardless of the amount involved in the transaction. Sales of principal residences, however, are subject to testing for adequacy of stated interest under amended section 483 (see discussion below).[38]

Personal-use property.—Section 1274 exempts cash-method issuers (but not holders) of debt instruments issued in exchange for property substantially all of which will not be used by the issuer in a trade or business or held by the issuer for the production or collection of income. Thus, such issuers may claim interest deductions only for amounts actually paid during the taxable year.

Annuities.—Section 1274 does not apply to an annuity to which section 72 applies and the liability for which depends in whole or in substantial part on the life expectancy of any individual. This exception applies only if the contingency is genuine and significant. Thus, it does not apply if the possibility that the life contingency will determine the amount of the annuity payments is remote.

In addition, section 1274 does not apply to any annuity (whether or not dependent upon life expectancy) issued by an insurance company subject to tax under Subchapter L, provided the annuity is issued (1) in a transaction in which only cash or another annuity contract meeting the requirements of this exception is tendered for the annuity, (2) upon exercise of an election under a life insurance policy by a beneficiary thereof, or (3) in a transaction involving a qualified pension or employee benefit plan.

Patents.—An exception is provided for payments attributable to a transfer of a patent, provided the transfer is eligible for capital gain treatment under section 1235 and such payments are contingent upon the productivity, use, or disposition of the patent. Thus, the exception does not apply in the case of a deferred lump-sum amount payable for a patent.

Total payments not exceeding $250,000.—The Act exempts from section 1274 any debt instrument received as consideration for the sale or exchange of property if the sum of (1) the payments due under the instrument (whether designated principal or interest) and under any other debt instrument received in the sale, and (2) the fair market value of any other consideration received in the sale, does not exceed $250,000. This exception is subject to an aggregation rule similar to that provided under the farm sale exception.

Land transfers between related persons.—Finally, section 1274 does not apply to an instrument to the extent section 483(f), relating to certain sales of land between related parties, applies. Thus, interest attributable to that portion of a debt within the $500,000 limitation of section 483(f) is not subject to OID reporting.

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[37]Under H.R. 5361 (discussed below), sales of farms during a transitional period that would otherwise be subject to section 1274 under certain circumstances are exempt from the accrual reporting requirements and are subject to reduced minimum interest rates.

[38]Although other residences are subject to section 1274, special transitional rules may affect the applicable test rate. See discussion under "Effective Dates," below.

Regulatory authority

The Act authorizes the Treasury Department to issue regulations dealing with the treatment of transactions involving varying interest rates, put or call options, indefinite maturities, contingent payments, assumptions of debt instruments, or other circumstances.

Subject to certain limitations imposed by H.R. 5361, enacted subsequent to the Act,[39] the regulations may apply the OID and imputed interest provisions to assumptions of debts in connection with transfers of property, and transfers of property subject to debts, after December 31, 1984.

Under these regulations, a debt instrument bearing interest, unconditionally payable[40] at least semiannually, at a variable rate, will contain adequate stated interest for purposes of section 1274 if (1) the specified rate at least equals 110 percent of the Federal short-term rate (or other appropriate indices provided under regulations) in effect on the date the sales contract becomes binding, and (2) the contract calls for adjustment of the rate at six-month or shorter intervals.

It is anticipated that the regulations will also deal with the treatment of loans issued in connection with a sale of property in which the principal or interest is expressed in a currency other than U.S. dollars.

The regulatory authority granted to the Treasury Department includes the authority to modify the generally applicable rules where appropriate to carry out the purposes of the statute. Pursuant to this authority, the Treasury Department may provide for the application of lower Federal rates where the statutorily-determined rates are significantly higher than current interest rates due to a decline in rates between the base perio and the beginning of the effective period, or during the period a set of rates are in effect.

b. Modification of general OID provisions

In general

In addition to extending the OID rules to debt issued for nontraded property, the Act makes a number of changes to the general OID provisions. First, debt instruments issued by individuals and having a fixed maturity date more than one year from the date of issue are generally subject to the annual inclusion rules of section 1272.[41] An exception is provided for cash loans between individuals involving a principal amount of $10,000 or less, provided the lender is not engaged in the business of lending money and a principal purpose of the loan is not tax avoidance. Furthermore, a cash-method issuer of a discount obligation may not deduct original

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[39]H.R. 5361 (P.L. 98-612, October 31, 1984), is discussed more fully below.

[40]Interest is payable "unconditionally" for this purpose only if the failure to pay the interest will result in consequences to the borrower that are typical in normal commercial lending transactions. Thus, in general, interest will be considered payable unconditionally only if the failure to timely pay interest results in an acceleration of all amounts under the debt obligation or similar consequences.

[41]There is no "floor" on total payments for cash loans, or loans with respect to publicly traded property, as in the case of purchase money loans involving nontraded property. (As previously discussed, section 1274 does not apply to a debt instrument if the total payments do not exceed $250,000.)

issue discount under section 163(e) if the proceeds of the loan are used to purchase property substantially all of which will not be used by the issuer in a trade or business or held for investment.

Second, the Act eliminates the exception to the OID rules of prior law (sec. 1232A(a)(1)) for debt instruments that are not capital assets in the hands of the holder. In this regard, the Act makes it clear that OID may arise if services are performed or the use of property is provided in exchange for a publicly traded debt instrument (sec. 1273(b)(5)).[42]

Congress did not intend to change the treatment of cash-method issuers of obligations maturing in one year or less. A cash-method taxpayer issuing a short-term debt instrument, whether in exchange for cash or in exchange for property, is subject to prior law rules governing deductibility of interest on short-term obligations.

Under section 44(j) of the Act, the amendments to the OID rules do not affect any debt instruments subject to effective date provisions of any predecessor of the OID rules, including transitional rules.

Reporting requirements

The Act authorizes the Treasury Department to require the issuer of a discount obligation to set forth the amount of the original issue discount and the issue date of a debt instrument on its face (sec. 1275(c)(1). If the instrument is privately placed, however, this requirement may not be imposed prior to a disposition of the instrument by the initial holder. In addition, issuers of publicly issued OID obligations must disclose to the Treasury Department the amount of the OID on the obligation, the issue date, and other information required under regulations (sec. 1275(c)(2)).

Issuers required to set forth information on the face of an instrument are subject to a penalty of $50 for each instrument for which this requirement is not met (sec. 6706(a)). Issuers required to disclose the amount of OID and other information under section 1275(c)(2) are subject to a penalty, equal to the smaller of one percent of the aggregate issue price or $50,000 (sec. 6706(b)).[43]

c. Modification of rules for allocating principal and interest in deferred payment transactions not subject to the OID rules

The scope of section 483 is significantly reduced under the Act, since a debt-for-nontraded property transaction is generally subject to testing for interest adequacy under section 1274. The purpose of section 483 as amended by the Act is to test the adequacy of interest in transactions specifically excepted from section 1274 (for example, sales of a principal residence, certain sales of farms, and transactions involving total payments of $250,000 or less.

The Act revises the interest rates used in section 483 to conform to the new rates used for obligations subject to section 1274. Thus, new section 483 employs compound safe-harbor and imputation

[42]For the treatment of deferred payments for services not involving a traded debt instrument, *see* secs. 404 and 404A, and sec. 467, as added by the Act; for the treatment of deferred payments for use of property, see sec. 467.

[43]For additional modifications to the general OID rules, see discussion in "Definitions and technical amendment," section 1, supra.

rates which vary according to the maturity of the obligation, and which are recomputed by the Treasury Department at six-month intervals.

The Act also revises the method of computing the interest element of payments made in a transaction containing inadequate stated interest. Interest income or expense is computed on an economic accrual basis consistent with Rev. Rul. 83-84. As under prior law, unstated interest must be reported or deducted when payment is made (in the case of a cash method taxpayer) or due (in the case of an accrual method taxpayer).

The exceptions of prior law for transactions in which the sales price does not exceed $3,000 and for annuities under section 72 are retained. The Act also retains the prior law rule under which the maximum test rate applicable to real estate transactions between related parties involving $500,000 or less is 6 percent (sec. 483(f)). Finally, the Act continues the exception for transfers of patents when payment is contingent upon the productivity, use, or disposition of the property transferred.[44] The exception for sales of ordinary income property in prior law, however, is eliminated.

A further exception to section 483 is provided for cash-method issuers (but not holders) of obligations issued in exchange for property substantially all of which will not be used by the issuer in a trade or business or held by the issuer for investment purposes. Congress intended that this exception apply to the purchaser of a home who intends to use part of the home as an office.

In the case of a sale of a principal residence where the purchase price does not exceed $250,000 or of farm land where the price does not exceed $1 million, the test rate and imputation rate under section 483 are the rates established by Treasury regulation in the manner provided under prior law.[45] If the purchase price of a principal residence exceeds $250,000, the prior law rates apply to the portion of the deferred payments that $250,000 bears to the sales price; the rates based on the applicable Federal rate apply to the remainder.[46]

d. Modification of regulations under section 482

In connection with the revision of section 483, the Act directs the Treasury Department to amend the section 482 regulations to provide safe-harbor interest rates for sales between commonly controlled organizations, trades, or businesses consistent with the rates applicable under new sections 483 and 1274.

Congress did not intend that sections 1274 and 483 as amended supersede section 482 in the case of deferred payment sales of property between commonly controlled organizations. Thus, the Act does not affect the Commissioner's regulatory authority to test the

[44] As under section 1274, Congress intended that this exception apply only if the transfer qualifies for capital gain treatment under section 1235. The exception under section 483 of prior law was held to apply to the transfer of any patent described in section 1235(a), without regard to the other requirements of section 1235.

[45] Although the test rate was a simple rate under the prior regulations, both this rate and the imputation rates are compound rates, based on semiannual compounding, for post-1984 transactions.

[46] This limitation is subject to certain transitional rules described below. Thus, a sale of a residence after December 31, 1984, and before July 1, 1985, that does not involve a "borrowed amount" in excess of $2 million is subject to a test rate of 9 percent, compounded semiannually.

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interest rate charged by one member of a controlled group with respect to a loan to another member of the group extended in the course of a sale of property under an arm's-length standard.

Effective Dates

Deficit Reduction Act

Under the Act, the amendments to the OID rules as they relate to nontraded property transactions and the amendments to section 483 generally are effective for sales or exchanges occurring after December 31, 1984. The rule that the principal amount of a debt instrument received in exchange for property is limited to the property's fair market value applies to transactions within section 483 of prior law occurring after February 29, 1984, and before January 1, 1985. An exception to the revised OID and section 483 rules is provided, however, for post-1984 transactions for which there was a binding commitment in writing on February 29, 1984.[47]

The Act also makes it clear that interest incurred with respect to debt instruments issued after June 8, 1984, and prior to January 1, 1985, may not be deducted prior to the period to which it is properly allocable. The principles of Rev. Rul. 83-84, 1983-1 C.B. 97, apply in determining interest allocable to a period. Thus, if a note issued during this period calls for simple interest at a rate at or above the section 483 test rate (i.e., 9 percent, compounded semiannually or 9.2 percent, compounded annually), the borrower may not accrue interest on the note based on the simple interest rate unless all interest is paid currently. Rather, the rate must be restated as a compound rate, and interest accruals must be computed on this basis.

The proscription against noneconomic accruals also applies to debt instruments issued after December 31, 1984, not subject to section 1274 and stating adequate interest for purposes of section 483.[48] This limitation does not apply, however, in the case of a debt instrument pursuant to which the issuer of the instrument makes substantially equal annual payments of principal and interest to the holder.[49]

The repeal of the capital asset limitation is effective for obligations issued after December 31, 1984, for obligations that are not capital assets in the hands of the holder. The repeal of the individual issuer exception is effective for obligations issued after March 1, 1984. The information reporting requirements are effective for debt obligations issued after August 17, 1984.

Subsequent modifications (H.R. 5361)

After the enactment of the Deficit Reduction Act, Congress passed further legislation (H.R. 5361) amending the OID and imputed interest rules. [50] H.R. 5361 provides transitional rules under

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[47]For this purpose, a binding commitment includes an irrevocable written option.

[48]*See* sec. 461(h) of the Code, as amended by the Act, relating to accrual of expenses.

[49]That is, the loan is fully self-amortizing, with no balloon payment at maturity. *Cf.* Rev. Proc. 83-40, 1983-1 C.B. 774.

[50]Pub. L. 98-612, October 31, 1984. A technical correction may be necessary to clarify that H.R. 5361 does not accelerate the effective dates of the OID and imputed interest provisions as enacted by the Deficit Reduction Act.

which lower safe-harbor rates will apply to most transactions after December 31, 1984, and before July 1, 1985, involving not more than $2 million of borrowing. The legislation also provides permanent rules for applying sections 483 and 1274, as amended by the Deficit Reduction Act, to assumptions of loans.

Lower test and imputation rate for certain transactions

With two exceptions described below, the amendments made by H.R. 5361 do not affect the applicability of section 483 or 1274 to a transaction; only the applicable test and imputation rates are affected, and only for the six-month period ending June 30, 1985. As amended, sections 483 and 1274 apply a test rate of 9 percent[51] if the principal amount of the purchase money loan from the seller to the buyer does not exceed $2 million and the property is not new section 38 property in the hands of the buyer. The imputation rate applied in these circumstances is 10 percent. If the borrowed amount exceeds $2 million, the test rate is a weighted average ("blend") of 9 percent and the amount that represents 110 percent of the applicable Federal rate.[52] Similarly, the imputation rate is a blend of 10 percent and 120 percent of the applicable Federal rate.

In applying the $2 million limitation, all sales which are part of the same transaction or series of related transactions are treated as one transaction, and all debt instruments arising from the same transaction or series of related transactions are treated as one debt instrument. Thus, if a seller sells a property to a buyer in two stages pursuant to a plan to sell the entire property, the two transactions will be viewed as a single sale and only $2 million of seller financing will be allowed at the 9 percent rate.

Cash-cash accounting for certain farm sales

H.R. 5361 alters the accounting treatment for interest in certain transactions involving farm property. If a transaction involves a sale or exchange of property used in the active trade or business of farming and the borrowed amount is $2 million or less, the buyer and seller must report interest income and deductions on the cash method of accounting, regardless of their usual method of accounting.

Assumptions

Pursuant to the Deficit Reduction Act, the Treasury Department is to prescribe regulations under which section 483 or 1274 will apply to an assumption of a debt obligation in connection with a sale of property, or the taking of property subject to an obligation, after December 31, 1984. H.R. 5361 provides several exceptions to this general rule.

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[51] Consistent with the formula for discounting payments under section 1274(b)(2) and (c)(3) and section 483(b) and (c)(1), the test and imputation rates assume semiannual compounding of interest. As previously indicated, adjustments to the 9 and 10 percent rates are necessary if an instrument calls for payments more or less frequently than semiannually.

[52] The blended test rate is determined by adding to 9 percent the product of (1) 110 percent of the applicable Federal rate minus 9 percent, and (2) a fraction, the numerator of which is the excess of the borrowed amount over $2 million, and the denominator of which is the borrowed amount.

First, a purchase money loan made on or before October 15, 1984, and assumed after December 31, 1984, in connection with a sale of property, is not subject to section 483 or section 1274 by reason of such assumption. This exception also applies if property is taken subject to a purchase money loan made on or before October 15, 1984, rather than personally assumed. This exception does not apply, however, if the purchase price of the property exceeds $100 million.[53]

The second major exception relates to assumptions of loans in connection with sales of residences, farms, and trades or businesses meeting certain requirements.

Residences.—A sale of a residence by an individual, estate, or testamentary trust is exempt from the general assumption rule if either (1) at the time of the sale, the property was the seller's principal residence within the meaning of section 1034, or (2) during the two-year period prior to the sale, no substantial portion of the property was subject to an allowance for depreciation. Thus, an assumption of a loan in connection with the sale of a principal residence, or of a vacation home on which a taxpayer may not claim depreciation (e.g., by reason of sec. 280A), generally is not subject to testing for unstated interest under section 483 or 1274. This exception does not apply, however, to a sale of property that was at any time held by the seller for sale to customers in the ordinary course of business.

Farms.—A sale by a "qualified person" of real property used as a farm[54] at all times during the three-year period prior to the sale, or of tangible personal property used by the seller in the active conduct of a farming business, for use by the buyer in the active conduct of a farming business, is also exempt from the general assumption rule. The term "qualified person" includes an individual, estate, or testamentary trust, or a corporation or partnership having 35 or fewer shareholders or partners, owning at least a 10-percent interest in the farm.

Trades or businesses.—Finally, a sale by a "qualified person" of a trade or business is exempt from the general assumption rule. Trade or business has the same meaning as under section 355, except that the rental of real estate under no circumstances qualifies as an active business for this purpose. A qualified person means an individual, estate, or testamentary trust, or corporation or partnership with 35 or fewer shareholders or partners, having at least a 10 percent interest in the trade or business.[55] The sale must constitute a disposition of the seller's entire interest in the trade or business and in all substantially similar trades or businesses.

An exception is also provided for a sale of real property used in an active trade or business (as defined above) by someone who

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[53] Due to a clerical error in the bill, the exception was stated as applying only if the purchase price *exceeds* $100 million. A technical amendment is necessary to correct this error.

[54] "Farm" for this purpose has the same meaning as under section 6420(c)(2), and thus includes "stock, dairy, poultry, fruit, fur-bearing animal, and truck farms, plantations, ranches, nurseries, ranges, greenhouses or other similar structures used primarily for the raising of agricultural or horticultural commodities, or orchards."

[55] This ownership interest must be readily ascertainable by reason of qualified allocations (of the type described in sec. 168(j)(9)(B)), one class of stock, or the like. For example, an ownership interest in a partnership is not readily ascertainable if the partnership agreement provides for disproportionate allocations of income or losses.

would be a qualified person but for the fact that his entire interest in the trade or business is not being sold. Thus, for example, a casual sale by a sole proprietor of real property used in his business could be exempt from the general assumption rule.

The trade or business property exception does not apply to a sale of property qualifying under the farm exception, or to property that is new section 38 property in the buyer's hands.

The Treasury Department is to prescribe regulations exempting from the general assumption rule transactions not likely to reduce significantly the tax liability of the purchaser through overstatement of its basis in the acquired asset.[56]

Revenue Effect

These provisions are estimated to increase fiscal year budget receipts by $218 million in 1985, $660 million in 1986, $1,184 million in 1987, $1,730 million in 1988, and $2,302 million in 1989.

[56] A technical correction is necessary to reflect this interpretation of the provision.

D. Corporate Tax Provisions

1. Debt-financed Portfolio Stock (sec. 51 of the Act and sec. 246A of the Code)[1]

Prior Law

In general, a corporate shareholder can deduct 85 percent of dividends received from other corporations. Thus, the maximum effective rate of tax on dividends received by a corporation is only 6.9 percent. In addition, interest paid or accrued within the taxable year on indebtedness generally is deductible. Under prior law, if a corporation borrowed money and used the proceeds to purchase dividend-paying stock, interest on the indebtedness generally was deductible against ordinary income. Further, there was no reduction in the amount of the dividends received deduction otherwise available to the shareholder corporation.

Reasons for Change

The purpose of the dividends received deduction is to reduce multiple corporate-level taxation of income as it flows from the corporation that earns it to the ultimate noncorporate shareholder. However, under prior law, when dividends were paid on debt-financed portfolio stock, the conjunction of the dividends received deduction and the interest deduction enabled corporate taxpayers to shelter unrelated income. The Congress believed that these two deductions were not intended to provide such shelter.

Specifically, under prior law, corporate taxpayers were borrowing money and using the proceeds to acquire dividend-paying portfolio stock. On the receipt of dividends paid with respect to such stock, such corporate taxpayers generally qualified for dividends received deductions, which reduced the amount of tax paid on the dividends. Further, the fact that the loan proceeds were used to generate tax-favored dividend income did not limit the deduction for interest paid or accrued on the indebtedness. Thus, in many cases, corporate taxpayers qualifying for a dividends received deduction were able to use the deduction for interest paid or accrued on indebtedness incurred to acquire the dividend-paying stock to shelter unrelated income. If the indebtedness was non-recourse, the transaction may have involved little risk and, if properly structured, may not even have had to be fully reflected on the investing corporation's balance sheet. Furthermore, when debt-financed pur-

[1] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 51, H. Rep. No. 98-432, Pt. 2 (March 5, 1984), p. 1180; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 31; S. Prt. 98-169, Vol. I (April 2, 1984), p. 165; Senate floor amendment, 130 Cong. Rec. S3938 (April 5, 1984); H. Rep. No. 98-861 (June 23, 1984), p. 811 (Conference Report).

chases of stock were used in a corporate takeover attempt, the tax system may, in effect, have been subsidizing the takeover attempt.

Explanation of Provision

In general

The provision generally reduces the deduction for dividends received on debt-financed portfolio stock so that the deduction is available, in effect, only with respect to dividends attributable to that portion of the stock which is not debt financed. Generally, this is accomplished by determining the percentage of the cost of an investment in stock which is debt financed and by reducing the otherwise allowable dividends received deduction with respect to any dividends received on that stock by that percentage. However, it was not intended that any reduction in the amount allowable as a dividends received deduction exceed the amount of the interest deduction allocable to the dividend. Nor was it intended to provide any dividends received deduction which, but for the provision, would not be allowed.

Debt-financed portfolio stock

Under the provision, the term "debt-financed portfolio stock" is defined as any "portfolio stock" with respect to which there is "portfolio indebtedness" at any time during the "base period."

Portfolio stock

Under the provision, stock of a corporation is portfolio stock unless specifically excluded. Stock is specifically excluded if, as of the beginning of the ex-dividend date for the dividend involved, the taxpayer owns stock (1) possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote, and (2) having a value equal to at least 50 percent of the value of all the stock, of such corporation. In addition, stock is specifically excluded if, as of the beginning of the ex-dividend date for the dividend involved, (1) the taxpayer owns stock of such corporation possessing at least 20 percent of the voting power and value of all the stock of such corporation, and (2)5 or fewer corporate stockholders own, directly, stock of such corporation possessing at least 50 percent of the voting power and value of all the stock of such corporation. This latter rule exempts certain corporate joint ventures from the provision.

In determining whether stock is portfolio stock, a corporation shall be treated as owning stock of a bank or a bank holding company which it has an option to acquire if, as of the beginning of the ex-dividend date for the dividend involved, the taxpayer owns stock having a value equal to at least 80 percent of the value of all the stock of the corporation.

For purposes of determining whether stock owned by a taxpayer is portfolio stock, ownership of stock described in section 1504(a)(4), as added by the Act, is disregarded.

Portfolio indebtedness and directly attributable

The term "portfolio indebtedness" means any indebtedness which is "directly attributable" to investment in portfolio stock with respect to which a dividend is received.

Under the provision, the directly attributable requirement will be satisfied if there is a direct relationship between the debt and investment in portfolio stock. The provision regarding investment in portfolio stock does not incorporate any allocation or apportionment formula or fungibility concept. Thus, for example, the provision does not apply merely as a result of (1) the existence of outstanding commercial paper that is issued by a corporation as part of an ongoing cash management program, or (2) deposits received by a depository institution as a part of the ordinary course of its business. Nor does the provision apply merely as a result of the existence of unsecured long-term debt incurred by a corporation engaged in the commercial or consumer finance business in the ordinary course of that business. However, if indebtedness is clearly incurred for the purpose of acquiring dividend-paying portfolio stock or otherwise is directly traceable to such an acquisition, the indebtedness would constitute portfolio indebtedness. Thus, for example, if portfolio stock were held in a margin account with a securities broker, the margin borrowing would constitute portfolio indebtedness. Similarly, if a corporation buys portfolio stock, issuing its own debt obligation to the seller, that obligation would constitute portfolio indebtedness. The same result would follow with respect to any nonrecourse loan secured, in whole or in part, by dividend-paying portfolio stock. The directly attributable standard generally is also met when a taxpayer, close to an ex-dividend date, buys one stock and sells a similar stock short, closing out both positions just after the 46-day holding period. In such a case, the short sale would be considered as a borrowing directly attributable to the purchase of the long position until the short sale is closed.

The provision also applies where indebtedness is directly attributable to the carrying of dividend-paying portfolio stock. For example, assume that an acquisition of stock is not debt-financed. Assume further that, at a later date, the purchaser obtains a loan in exchange for a note the security for which is the portfolio stock. If, under the circumstances, it would have been reasonable for the purchaser to have sold the portfolio stock to raise the cash, the provision would be applicable.

The provision does not preclude the use of a "look-through" rule. That is, the provision is not rendered inapplicable merely because the borrower and the holder of the dividend-paying portfolio stock are different persons. However, as an exception to a look-through approach, indebtedness of a taxpayer is not directly attributable to portfolio stock held by a corporation all or substantially all of the stock of which is acquired by the taxpayer if (1) the portfolio stock is held by the acquired company in the active conduct of a trade or business, and (2) the practice of making portfolio stock investments is an integral part of the acquired corporation's trade or business. Thus, for example, if the taxpayer makes a 100-percent debt-financed acquisition of all of the stock of a life insurance company, and such company uses its capital and surplus to make investments in portfolio stock of other corporations, the provision does not apply. The taxpayer is really acquiring an active business, not portfolio stock. In contrast, however, if the taxpayer makes a debt-financed acquisition of 100 percent of the stock of a mere investment company, the provision may apply to disallow a dividends received deduction of the investment company. For this purpose, a mere investment company is any company described in section 533(b).

Computation of allowable deduction

In lieu of the 85-percent deduction which is generally available (sec. 243(a)(1), sec. 244(a)(3), and sec. 245), the deduction is limited to that percentage of the dividend determined by computing the product of (1) 85 percent, and (2) 100 percent minus the average indebtedness percentage. Under regulations to be prescribed by the Secretary, the average indebtedness percentage is obtained by dividing (1) the average amount of the portfolio indebtedness with respect to the portfolio stock during the base period, by (2) the average amount of the adjusted basis of such stock during the base period. The term "base period" means, with respect to any dividend distribution, the shorter of (1) the period beginning on the ex-dividend date for the most recent previous dividend on the stock and ending on the day before the ex-dividend date for such dividend, or (2) the 1-year period ending on the day before the ex-dividend date for such dividend.[2] Finally, any reduction in the amount allowable as a dividends received deduction under the rule is to be limited to the amount of the interest deduction allocable to the dividend (including any short sale expenses related to short positions treated as debt for purposes of determining the average indebtedness percentage).

An example is illustrative.

Assume that Corporation A pays a dividend of $1 per share each quarter, that the ex-dividend dates are January 15, April 15, July 15, and October 15, and that the dividend payment dates are February 1, May 1, August 1, and November 1. Assume further that on January 15, 1985, Corporation B buys 1,000 shares of A stock for a total cost of $100,000, financing 60 percent of the acquisition by borrowing $60,000. Also assume that the interest rate on the debt is 14 percent and that in B's hands the A stock is portfolio stock. Finally, assume that on April 14, 1985, while the full amount of the debt remains outstanding, B becomes entitled to a $1,000 dividend on the stock. B is entitled to a dividends received deduction. However, under the provision, that deduction cannot exceed $340. The deduction is limited to 85 percent x (100 percent minus the average indebtedness percentage). Under the rules described above, the average indebtedness percentage is the average amount of portfolio indebtedness ($60,000) divided by the average amount of the adjusted basis of the stock ($100,000), or 60 percent. Thus, in the example,

[2] For any portfolio stock that is not held by the taxpayer throughout the base period, the rules are applied by taking into account only the portion of the base period during which the stock was held by the taxpayer. However, the average indebtedness percentage is not to be reduced merely because the portfolio stock is not held by the taxpayer throughout the base period.

the maximum deduction is 34 percent (85 percent x (100 percent minus 60 percent)).

The Congress intended that if, by reason of section 245 (relating to dividends received from certain foreign corporations), only part of a dividend is eligible for a deduction under section 243, then that part shall be subject to further reduction under section 246A. For example, assume that in the above example the corporation paying the dividend is a foreign corporation described in section 245(a) and that 60 percent of its gross income for the taxable year is effectively connected with the conduct of a trade or business in the United States. In such case, the maximum deduction should be 20.4 percent (34 percent x 60 percent). A technical amendment may be appropriate to effectuate this intent.

Related parties

As indicated above, the portfolio indebtedness is not required to be that of the holder of the dividend-paying stock to satisfy the directly attributable test. Thus, for example, the provision may apply in a case where 1 member of an affiliated group of corporations incurs the portfolio indebtedness and another member of the group acquires the dividend-paying stock. In addition, the provisions of section 7701(f) (relating to regulations to prevent the use of related persons, pass-through entities, or other intermediaries as a means of avoiding the effect of provisions linking borrowing to investment), as added by section 53 of the Act, are applicable.

Disallowance of interest deduction

The provision generally operates on the dividends received deduction. However, the Treasury is granted authority to issue regulations providing for the disallowance of an interest deduction or other appropriate treatment in lieu of reducing the dividends received deduction where the obligor is a person other than the person receiving the dividend. For example, assume that two unrelated corporations, A and B, acquire all of the stock of a third unrelated corporation, C, with A using borrowed funds to acquire 30 percent of the C stock and B using equity funds to acquire the remaining 70 percent. If the money borrowed by A is directly attributable to investment in dividend-paying portfolio stock by C, under such regulations, there should be no reduction in C's dividend received deduction. Rather, the deduction for interest paid or accrued by A on its debt should be reduced or disallowed, or other appropriate treatment (e.g., the equivalent of a recapture of interest deductions) provided. This result is more appropriate than a reduction in C's dividends received deduction because such a reduction would, in effect, penalize both A and B even though B's investment was not debt financed.

Exceptions

The provision was not intended to apply to dividends from 1 member of an affiliated group of corporations filing consolidated returns to another member of that group. Furthermore, the Act provides specific exceptions for dividends eligible for the 100-percent dividends received deduction (generally determined under section 243(b)) and for dividends received by a small business investment company operating under the Small Business Investment Act of 1958.

Effective Date

The provision applies to stock the holding period for which begins after the date of enactment (July 18, 1984). For this purpose, the beginning of a holding period is to be determined without regard to any suspension of it under section 246(c).

Revenue Effect

The provision is estimated to increase budget receipts by less than $10 million per year.

2. Certain Dividends From Regulated Investment Companies (sec. 52 of the Act and sec. 854 of the Code)[3]

Prior Law

Domestic corporations are generally entitled to an 85-percent dividends received deduction with respect to dividends from other corporations. No similar deduction is available with respect to interest income. Individuals are generally entitled to exclude from gross income up to $100 of dividend income. No similar exclusion is available with respect to interest income.

Mutual funds, or regulated investment companies ("RICs"), are generally not subject to tax if they distribute their income to their shareholders. In such event, the income is generally taxed to the shareholders directly. Under prior law, if 75 percent or more of a RIC's gross income for a taxable year consisted of dividends from domestic corporations, then all distributions from such RIC (other than capital gain dividends) were treated by the shareholders as dividends eligible for the dividends received deduction or the dividend exclusion. If less than 75 percent of the RIC's gross income for the year consisted of dividends from domestic corporations, distributions (other capital gain dividends) were treated as, in part, a dividend, and, in part, as other income in a proportion equal to the ratio of the RIC's aggregate dividend income for the taxable year to its gross income for the year.

It was not clear under prior law whether a dividend received by a RIC would be treated as a dividend if it was received under circumstances in which the RIC, had it been a regular corporation, would not have been entitled to a dividends received deduction. Furthermore, it was unclear whether a RIC's short-term capital gain from the sale of stock or securities was treated as gross income for purposes of determining what percentage of its gross income was dividend income. See Rev. Rul. 80-345, 1980-2 C.B. 204 (holding that such income was to be treated as gross income for that purpose).

Reasons for Change

Under prior law, the treatment by shareholders of a RIC of amounts received from the RIC as dividend income under circumstances in which the distribution was paid out of dividend income (including dividend income as to which the RIC, had it been a regular corporation, would not have been entitled to a dividends re-

[3] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 52; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), p. 1183; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 52; S. Prt. 98-169, Vol. I (April 2, 1984), p. 168; Senate floor amendment, 130 Cong. Rec. S3938 (April 5, 1984); and H. Rep. No. 98-861 (June 23, 1984), pp. 814-815 (Conference Report).

ceived deduction) and other income permitted conversion of ordinary taxable income into tax-favored dividend income. The Congress believed that under a system in which tax consequences are different depending on the source of the income, conversion of income taxed at ordinary income rates into income taxed at more favorable rates was inappropriate.

Explanation of Provision

The provision makes a number of changes in the treatment of dividends received from a RIC. First, the dividends received deduction for corporate shareholders with respect to a dividend from a RIC is computed by taking into account only that portion of the distribution that is designated by the RIC as being paid out of dividend income eligible for the dividends received deduction. Second, if (but only if) less than 95 percent of the RIC's gross income for the taxable year consists of dividends from domestic corporations, the amount of any distribution that is treated by an individual shareholder as a dividend for purposes of the dividend exclusion is limited to amounts designated by the RIC. Third, net short-term capital gains from dispositions of stock or securities in excess of net long-term capital losses from dispositions of stock or securities are treated as gross income for purposes of these rules.

The purpose of the designation requirement is to insure that income received by a RIC retains its character when it is distributed by the RIC to its shareholders. Thus, the aggregate amount designated as dividends eligible for the dividends received deduction or, assuming the 95-percent test described above is not satisfied, the dividend exclusion for any taxable year cannot exceed the aggregate amount of dividend income received by the RIC during the taxable year. Further, for purposes of designating the portion of a distribution that is to be treated by a corporate shareholder as a dividend eligible for the dividends received deduction, an amount received by the RIC is generally to be treated by the RIC as a dividend only if the RIC would have qualified for a dividends received deduction with respect to such amount if it were a regular corporation. Finally, it was intended that the designation of dividend income must generally be the same for all shares of the RIC's stock.

Effective Date

The provision is effective for all taxable years of a RIC beginning after the date of enactment (July 18, 1984).

The Congress anticipated that the Secretary will withhold any required consent if any RIC seeks to change its taxable year to take advantage of prior law and the effective date of the provision.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $2 million in 1984 and by $5 million per year in 1985–89.

3. Treatment of Certain Distributions to Corporate Shareholders (secs. 53 and 54 of the Act and secs. 246, 301, and 1059 of the Code)[4]

Prior Law

Overview

The prior-law rules governing distributions by corporations to certain corporate shareholders presented opportunities for tax avoidance. Corporate shareholders took particular advantage of the rules relating to the basis of dividend-paying stock, the basis and holding period of property distributed by 1 corporation to another, and the holding-period requirement for the dividends received deduction.

General rules

In general, the amount of a distribution by a corporation to its shareholders is includible in a shareholder's gross income as a dividend to the extent the distribution is made out of the corporation's earnings and profits. If the distribution exceeds the corporation's earnings and profits, the balance is applied against and reduces the basis of the stock with respect to which the distribution is made. To the extent the distribution exceeds the basis of the stock, the excess is treated as gain from the sale or exchange of property.

A corporate shareholder is generally permitted to deduct 85 percent of the amount of dividends received from domestic corporations. Thus, because the maximum rate of tax on income received by a corporation is 46 percent, the maximum rate of tax on dividends received by a corporation is only 6.9 percent. Distributed amounts that are treated as gain from the sale or exchange of property are taxed as capital gain if the stock with respect to which the distribution is made constitutes a capital asset. Net short-term capital gain in excess of net long-term capital loss is taxed to a corporation at ordinary income rates of up to 46 percent. A corporation's net capital gain (the excess of net long-term gain over net short-term loss) is subject to an alternative tax of 28 percent if the tax computed using that rate is lower than the corporation's regular tax.

Basis of dividend-paying stock

Under prior law, except where the amount of a dividend exceeded the distributing corporation's earnings and profits, the receipt of

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[4] For legislative background of the provisions, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, secs. 53 and 54; H.R. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1184-1189 and p. 1194; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, secs. 35 and 36; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 170-176; Senate floor amendment, 130 Cong. Rec. S3938-39 (April 5, 1984); and H.R. Rep. No. 98-861 (June 23, 1984), pp. 816-819 (Conference Report).

a dividend generally had no effect on a shareholder's basis in the dividend-paying stock unless the 2 corporations were filing a consolidated return.

Basis and holding period of property distributed by one corporation to another

In the case of a distribution of property other than cash to certain corporate shareholders, the corporate shareholder's basis in the distributed property, and the amount of the distribution, was the lesser of (1) the fair market value of the property, or (2) the adjusted basis of the property in the hands of the distributing corporation immediately prior to the distribution, increased by the amount of any gain recognized to the distributing corporation on the distribution.

If a corporate shareholder's basis in distributed property was determined by reference to its basis in the hands of the distributing corporation, the corporate shareholder's holding period for the property included the period during which such property was held by the distributing corporation (sec. 1223(2)). If the basis of the property was determined by its fair market value, the corporate shareholder's holding period in the distributed property generally began on the date of the distribution.

Distributions of stock in certain foreign corporations

In general, a domestic corporation that distributes appreciated stock in a controlled foreign corporation (generally, a foreign corporation more than 50 percent of the voting stock of which is owned by U.S. persons who own 10 percent or more of such stock) in a nonrecognition transaction to which section 311 applies is required to recognize its pro rata share of the foreign corporation's post-1962 earnings and profits as a dividend (sec. 1248(f)(1)). Under section 1248(f)(2), however, no amount is includible in income as a dividend if, among other things, the distribution is to a domestic corporate shareholder that is treated as holding the stock during the period the stock was held by the distributing corporation. Under prior law, nonrecognition treatment generally was accorded to the distributing corporation under section 311, and the exception in section 1248(f)(2) generally applied, where, *inter alia*, the corporate distributee's basis in the stock was determined by reference to the basis of the stock in the hands of the distributing corporation immediately before the distribution.

Suspension of holding period of dividend-paying stock

The 85-percent dividends received deduction was disallowed unless the taxpayer satisfied a 16-day holding period with respect to the dividend-paying stock (91 days in the case of certain dividends on stock having preference in dividends). The 16-day and 91-day holding periods did not include periods during which the taxpayer reduced or eliminated the risk of loss on the underlying stock by entering into a short sale of, acquiring an option to sell, or entering into a binding contract to sell substantially identical stock or securities.

Treasury regulations provided that, where preferred stock or bonds are convertible into common stock, the relative values, price changes, and other circumstances may be such that the bonds or preferred stock are treated as the common-stock equivalent. (See Treas. reg. sec. 1.246-2(a)(2) and Treas. reg. sec. 1.1233-1(d)(1)). Under the common-stock equivalent standard, the Internal Revenue Service ruled that convertible preferred stock and common stock of the same issuer are substantially identical where there are no restrictions on conversion, the instruments have the same voting and dividend rights, for a substantial period the instruments sell at prices that do not vary significantly from the conversion ratio, and the price of the convertible preferred stock adjusts to any fluctuation in price of the common stock. Rev. Rul. 77-201, 1977-1 C.B. 250.

Neither the statute nor the regulations addressed the issue of whether the holding period of dividend-paying stock is suspended if the taxpayer writes a covered call option (i.e., an option to buy the stock). A covered call option with a strike price that is equal to or in excess of the current market value of the underlying stock affords the writer no protection against loss, beyond the option premium received (which is typically small in relation to the value of the stock), if the stock declines in value. In Rev. Rul. 80-238, 1980-2 C.B. 96, the Internal Revenue Service ruled that the writing of a call option with a strike price that exceeds the current market value of the dividend-paying stock does not place the writer in a risk-free position and, thus, does not come within the intendment of the statute. Although the Internal Revenue Service noted that different considerations apply to a covered call option with a strike price below the current market value, because, the Internal Revenue Service reasoned, it is almost certain that such an option will be exercised, the revenue ruling provided no guidance regarding the circumstances in which the holding period of the underlying stock would be suspended in this case.

The dividends received deduction also was disallowed if the taxpayer was under an obligation, pursuant to a short sale or otherwise, to make a corresponding payment with respect to substantially identical stock or securities.

Reasons for Change

Under the prior-law rules governing the distribution of property by 1 corporation to another, corporate shareholders attempted to structure transactions to convert short-term capital gain to tax-favored dividend income or long-term capital gain, and into obtain the dividends received deduction without bearing the economic risk of holding the dividend-paying stock.

The absence of any requirement that a corporate shareholder's basis in certain newly-acquired stock be reduced on receipt of a dividend with respect to such stock encouraged taxpayers to engage in tax-motivated transactions such as "dividend stripping." Typically, dividend stripping involves acquiring stock shortly before the ex-dividend date, receiving a dividend that is eligible for the 85-percent dividends received deduction, and then selling the stock after satisfying the holding-period requirement for the dividends received deduction. Because the market price of the dividend-paying stock can be expected to decline by approximately the amount of the dividend, the corporate taxpayer ended up with dividend income (taxable at a maximum rate of 6.9 percent) and a short-term capital loss on sale of the stock. If the taxpayer had unrelated short-term capital gain (taxable at a maximum rate of 46 percent) that was offset by the short-term loss, then the taxpayer effectively converted that gain to tax-favored dividend income. Dividend stripping was engaged in widely when Chrysler Corporation paid four years of back dividends on its cumulative preferred stock: an $11.69 dividend on stock selling for $36.00 per share.

If the distribution consisted of appreciated property with a zero-basis in the hands of the distributing corporation immediately prior to the distribution, no amount would have been included in income by the corporate shareholder (and the availability or nonavailability of a dividends-received deduction would have been irrelevant), although the distributed property would have taken a zero basis in the shareholder's hands. Nonetheless, the short-term loss realized on the sale of the stock would have been recognized. Further, the application of the holding-period rule for distributed property provided an opportunity to convert short-term capital gain to long-term capital gain in the transaction. If the distributing corporation had held the distributed property for the holding period required for long-term gain treatment and the corporate distributee sold both the property and the dividend-paying stock, then the corporate shareholder realized a long-term gain on the sale of the property and a short-term loss on the sale of the stock. The short-term capital loss could offset short-term gains from other transactions, leaving the long-term gain to be taxed at more favorable rates. Changes made by the Act in the treatment of distributing corporations under section 311 (generally requiring the recognition of gain on most nonliquidating distributions of appreciated property) are likely to discourage such transactions. The Congress believed, however, that long-term capital gain treatment on disposition of a portion of its investment was inappropriate where the corporate shareholder recently made its investment in the distributing corporation, even if the distribution is not a taxable event to the distributing corporation. Under the new holding period rules, the gain on the sale of the distributed property would be short-term capital gain.

The prior-law rules regarding the circumstances in which a taxpayer would be treated as having reduced the risk of loss with respect to dividend-paying stock were not comprehensive. Thus, for example, taxpayers attempted to circumvent the statutory rules by acquiring dividend-paying common stock, entering into short sales of convertible preferred stock or convertible bonds of the same issuer, and claiming that the two positions were not substantially identical property under the stringent common-stock equivalent standard. If the taxpayer was required to make an "in lieu of" payment on the short position, the taxpayer could deduct the payment against ordinary income while claiming a dividends received deduction on the long position (effectively converting ordinary income to dividend income). While no inference as to the consequences under prior law of such a transaction was intended, in the view of the Congress, the holding of substantially similar or related positions that reduce the taxpayer's risk of loss should result in a tolling of the holding period of the dividend-paying stock.

The Congress also determined that the 16-day holding period requirement for the dividends-received deduction was inadequate to prevent dividend stripping.

The Congress believed that the Act's new rules requiring a reduction in a corporate shareholder's basis in stock on receipt of an extraordinary dividend and a "fresh-start" basis for distributed property, along with the new holding-period requirements for the dividends received deduction, would discourage the transactions described above.

Explanation of Provisions

a. Corporate shareholder's basis in stock reduced by reason of extraordinary dividend

Explanation

Under the Act, a corporate shareholder's adjusted basis in any share of stock that is held for 1 year or less is to be reduced by the nontaxed portion of any extraordinary dividend received with respect to such stock. (However, if the corporate shareholder and the payor of the dividend are part of an affiliated group filing consolidated returns, it was not intended that basis be reduced under both the provision and under Treas. reg. section 1.1502-32(b)(2)(iii).) If the amount of the nontaxed portion of an extraordinary dividend exceeds the shareholder's adjusted basis in the stock with respect to which the distribution was made, the excess is to be treated by the shareholder as gain from the sale or exchange of property. For purposes of determining whether stock has been held for only a year or less, the general holding period suspension rules applicable for purposes of the dividends received deduction, as amended by the Act, are applicable.

Extraordinary dividends are dividends that, in amount, equal or exceed 10 percent (5 percent in the case of a share of stock preferred as to dividends) of the corporate shareholder's basis (determined without regard to the provision) in the share of stock with respect to which the dividend is received. All dividends that have ex-dividend dates within a period of 85 days are treated as one dividend with respect to the dividend-paying stock. Further, all dividends that have ex-dividend dates within a period of 365 days are treated as extraordinary if the aggregate amount of such dividends exceeds 20 percent of the shareholder's basis (determined without regard to the provision) in such stock. Dividends are aggregated under these rules if received by the taxpayer, a person from whom the taxpayer acquired the stock if the taxpayer's basis in the stock is determined in whole or in part by reference to the basis of the stock in the hands of such person, or a person to whom the taxpayer transferred the stock if the transferee's basis in the stock is determined by reference to the basis of such stock in the hands of the taxpayer.

Solely for purposes of this provision, in the case of a distribution of property other than cash, the amount of the dividend is the fair market value of the property (reduced, as provided in section

301(b)(2), for liabilities assumed by the shareholder or to which the property is subject). The nontaxed portion of a dividend is the amount of the dividend, as so determined, less any portion thereof that is not offset by a dividends received deduction and is includible in income.

A distribution which, had it qualified as a dividend, would have been treated as an extraordinary dividend is to be treated under the provision as an extraordinary dividend even though the distributing corporation has no earnings and profits (or an amount of earnings and profits that is less than the amount of the distribution). In such a case, however, the amount treated as an extraordinary dividend (as determined under the provision) is reduced by the amount of any reduction in stock basis under section 301(c)(2).

A distribution in redemption of stock that is treated as a distribution under section 301, rather than as a sale or exchange of the redeemed shares under section 302(a), may be an extraordinary dividend. In such case, the dividend is to be treated as made, pro rata, with respect to the stock of the shareholder which is not redeemed.

The Treasury is authorized to prescribe regulations applying the provision in the case of stock dividends, stock splits, reorganizations, and other similar transactions.

Effective Date

The provision applies to distributions made after March 1, 1984.

Revenue Effect

It is estimated that the provision will increase fiscal year budget receipts by $140 million in 1985, $100 million in 1986, $100 million in 1987, $100 million in 1988, and $100 million in 1989.

b. Basis and holding period for property distributed by one corporation to another

Explanation

The Act amends the rules for determining the basis and holding period to a corporate shareholder of property received in a distribution by a corporation with respect to its stock. Under the Act, if the corporate shareholder's basis in the property received from the distributing corporation is determined by reference to its basis in the hands of the distributing corporation immediately prior to the distribution under section 301(d)(2)(B), and the distributing corporation does not recognize gain on the distribution, the corporate shareholder's holding period for the distributed property is deemed to begin no earlier than the date on which the stock with respect to which the distribution was made was acquired. Further, if the distributing corporation recognizes gain on the distribution under section 311, the corporate shareholder's basis in the distributed property is to be treated as the fair market value of such property under section 301(d)(2)(A) (and not the adjusted basis in the hands of the distributing corporation, increased by gain recognized to the distributing corporation, under sec. 301(d)(2)(B)), so the shareholder's holding period for the property would begin on the date of the distribution. The Act also amends section 311 to require a distributing corporation to recognize gain on most nonliquidating distributions of appreciated property. Thus, once the amendments to section 311 become fully effective, (generally, they apply to distributions declared on or after June 14, 1984, except that in the case of distributions to 80-percent corporate shareholders, they generally apply to distributions made after December 31, 1984) a corporate shareholder's holding period for property distributed to it by another corporation will generally begin on the date of the distribution.

The new rules for determining a corporate shareholder's holding period for distributed property do not apply for purposes of section 1248. Thus, the distribution of appreciated stock in a controlled foreign corporation by one domestic corporation to another may not trigger dividend income to the distributing corporation if, *inter alia,* the distributee shareholder is an 80-percent corporate shareholder and the distribution occurs before January 1, 1985. After section 311, as amended by the Act, becomes fully effective, such a distribution will trigger gain recognition (and dividend income under section 1248) to the distributing corporation. As a result, the distributee's holding period for the distributed stock will begin on the date of the distribution.

Effective Date

The provision applies to distributions made after the date of enactment.

Revenue Effect

The revenue effect of this provision is included in the explanation of the provision that requires a distributing corporation to recognize gain on most nonliquidating distributions of appreciated property.

c. Suspension of holding period of dividend-paying stock

Holding-period requirement

Under the Act, the 85-percent dividends received deduction is disallowed unless the taxpayer satisfies a 46-day holding period requirement. The 91-day holding period for certain preferred stock was retained.

Substantially similar or related standard

The 46-day holding period does not include any period during which the taxpayer reduces the risk of loss from holding the stock by: (1) entering into a short sale of, acquiring an option to sell, or entering into a binding contract to sell substantially identical stock or securities, (2) granting an option to buy substantially identical stock or securities, subject to an exception for a qualified covered call option (as defined for purposes of the provisions relating to tax straddles, but without regard to the requirement therein that gain or loss with respect to the option not be ordinary in nature), or (3) as prescribed in regulations, by reason of holding one or more other positions in substantially similar or related property.

The following transactions are examples of the types of transactions that are within the scope of the rule for substantially similar or related property: (1) a short sale of common stock when the taxpayer holds convertible preferred stock of the same issuer and the price changes of the convertible preferred stock and the common stock are related (the same result would obtain in the case of a short sale of a convertible debenture while holding stock into which the debenture is convertible, or a short sale of convertible preferred stock while holding common stock); and (2) the acquisition of a short position in a regulated futures contract ("RFC") on a stock index (or the acquisition of an option to sell the RFC or the stock index itself, or the grant of a deep-in-the-money option to buy the RFC or the stock index) while holding the stock of an investment company whose principal holdings mimic the performance of the stocks included in the stock index (or, alternatively, while holding a portfolio composed of stocks that mimic the performance of stocks included in the stock index).

The Act contemplates that regulations setting forth the application of the rule for substantially similar or related property to the transactions identified above will be generally effective as of the date of enactment of the bill, but that such regulations will be applied to other transactions on a prospective basis. No inference was intended regarding the circumstances under which the dividends received deduction would be disallowed under prior law where taxpayers wrote in-the-money calls with respect to stock they held. In addition, no inference was intended regarding what situations are covered under the prior-law rule applicable to substantially identical stock or securities.

Ordinarily, common stock in one corporation would not be viewed as substantially similar or related to common stock of another corporation. Where stocks of similar companies are involved, however, a short sale of preferred stock of one corporation while holding preferred stock of the other corporation may result in application of the risk reduction rule.

The substantially similar standard is not satisfied merely because the taxpayer (1) holds a single instrument that is designed to insulate the holder from market risks (*e.g.*, adjustable rate preferred stock that is indexed to the Treasury bill rate), or (2) is an investor with diversified holdings and acquires an RFC or option on a stock index to hedge general market risks. An investment in preferred stock coupled with an option to sell the stock will not be treated as a single instrument, for purposes of applying the substantially similar standard, without regard to whether the option trades separately from the stock.

Other rules

To the extent a taxpayer is obligated to make a dividend substitute or corresponding payment with respect to a position in substantially similar or related property, the dividends received deduction is disallowed.

Effective Date

The provision is effective with respect to stock acquired after the date of enactment (July 18, 1984).

Revenue Effect

The revenue effect of this provision is included in the explanation of the provision that reduces a corporate shareholder's basis in stock by reason of an extraordinary dividend.

4. Application of Related Party Rule to Various Code Provisions (sec. 53(c) of the Act and new sec. 7701(f) of the Code)[5]

Prior Law

Prior and present law (Code sec. 265(2)) disallow the deduction of interest incurred or continued to purchase or carry tax-exempt obligations. This rule applies both to individual and corporate taxpayers. The courts and the Internal Revenue Service have interpreted the rule to disallow an interest deduction only where a taxpayer incurred or continued indebtedness for the purpose of acquiring or holding tax-exempt obligations. Prior law was unclear as to how the section 265(2) disallowance rule applied when the taxpayer incurs debt and a related party acquires or holds tax-exempt obligations.

Prior and present law contain certain other provisions (in addition to sec. 265(2)) which deal with the linking of borrowing to investment or the diminishing of risks with respect to certain investments. The application of such rules to related party transactions under prior law was in certain cases also unclear.

Reasons for Change

The disallowance rule of section 265(2) is intended to prevent a double tax benefit through the receipt of tax-exempt interest plus a deduction for interest incurred in acquiring or holding the tax-exempt obligation. Congress believed that taxpayers should not be able to avoid this rule by incurring debt to finance the purchase of tax-exempt obligations by their spouses, minor children (in appropriate instances) or, in the case of corporations, by an affiliated corporation (whether or not the corporations file a consolidated return). For similar reasons, Congress believed that taxpayers should not be allowed to avoid the intended effect of other new and continuing tax law provisions which concern the linking of borrowing to investment, or the diminishing of risk, by using transactions involving related parties, pass-through entities, or other intermediaries.

Explanation of Provision

The Act (new Code sec. 7701(f)) provides that the Treasury Department is to prescribe such regulations as may be necessary or appropriate to prevent the avoidance of Federal tax provisions which deal with (1) the linking of borrowing to investment, or (2) diminishing risks, through the use of related persons, pass-through

[5]For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 188; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 513-514; and H. Rep. No. 98-861 (June 23, 1984), pp. 1041-1042 (Conference Report).

entities, or other intermediaries. Congress specifically intended that this provision will be applied to (but will not be limited to) section 265(2) of the Code.[6]

It was intended that, for purposes of section 265(2), related persons will include (1) spouses, and (2) a person and certain 80-percent entities with respect to such person (as defined for purposes of sec. 1239(b)). Additionally, in appropriate instances, related persons for purposes of section 265(2) will include an individual and any minor children of such individual.

Congress intended that this provision will not alter the prior and present law rule which disallows an interest deduction under section 265(2) only if the purpose of borrowing is to purchase or carry tax-exempt obligations.[7] In particular, Congress was aware that certain corporations engaged in banking, writing insurance, or issuing travelers checks hold large investment portfolios, including tax-exempt securities, that are required to be held to satisfy obligations to or for their customers in the ordinary course of business. Often these corporations do not have significant amounts of interest-bearing debt. In addition, these corporations are often affiliates of other corporations which have large amounts of interest-bearing debt. Congress intended that this provision not cause interest on borrowings by an affiliated company to be disallowed in any case where such interest would not be disallowed under prior law if the operations of the corporations were carried on as separate divisions of a single corporation. Thus, a deduction would not be disallowed merely because one corporation borrows in the ordinary course of its business operations and an affiliated bank, insurance company, or similar business holds tax-exempt obligations.[8]

The Code, as amended by the Act, contains certain provisions other than section 265(2) which apply specific rules in cases in which indebtedness is linked to certain kinds of investments. The Code, as amended by the Act, also contains many provisions (e.g., sec. 243) applying specific rules in cases in which a taxpayer reduces his or her risk of loss with respect to certain kinds of investments. Under the Act, the Treasury regulations regarding related parties, pass-through entities, or other intermediaries are to be applied to all of these provisions. No inference was intended that any other Code provision may be circumvented by the use of related parties, pass-through entities, or other intermediaries. Nor was any inference intended that any particular provision under prior law or as amended by the Act (e.g., sec. 265(2) or new sec. 246A), by its own terms, is not applicable in the case of related parties, pass-through entities, or other intermediaries.

Effective Date

The provision regarding related parties, pass-through entities, and other intermediaries was generally effective on July 18, 1984

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[6]Section 265(2) was not directly amended by the Act.

[7]See, e.g., *Leslie* v. *Commissioner*, 413 F.2d 636 (2d Cir. 1969), *cert. den.*, 396 U.S. 1007 (1970); *Wisconsin Cheeseman, Inc.* v. *United States*, 388 F.2d 420 (7th Cir. 1968); Rev. Proc. 72-18, 72-1 C.B. 740.

[8]See 130 Cong. Rec. S4511 (April 12, 1984) (colloquy between Sen. Percy and Sen. Dole); 130 Cong. Rec. H7112-7113 (June 27, 1984) (statement of Mr. Rostenkowski), S8409 (June 27, 1984) (statement of Sen. Dole).

(i.e., the date of enactment). However, for purposes of section 265(2) only, this provision was effective with respect to (1) term obligations incurred after July 18, 1984, and (2) demand obligations outstanding 60 days after the date of enactment (July 18, 1984).[9]

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by less than $5 million per year.

[9]It is anticipated that a technical correction will be recommended to clarify the effective date for purposes of section 265(2).

5. Distributions of Appreciated Property by Corporations (sec. 54 of the Act and sec. 311 of the Code)[10]

Prior law

Generally no gain or loss was recognized to a corporation on the distribution, with respect to its stock, of property. There were exceptions to this rule. First, such a distribution generally triggered recapture income, as under section 1245 (relating to depreciable personal property). Second, the distribution of LIFO inventory generally generated income in an amount equal to the LIFO reserve with respect to such inventory. Third, if a corporation distributed property which was subject to a liability, or the shareholder assumed a liability in connection with the distribution, gain was generally recognized to the distributing corporation to the extent the liability exceeded the adjusted basis of the distributed property in the hands of the distributing corporation.

In addition, under prior law, if a corporation distributed property in a redemption transaction to which subpart A (sections 301 through 307) applied, gain generally was recognized to the distributing corporation in an amount equal to the excess of the distributed property's value over its adjusted basis in the hands of the distributing corporation. However, there were several exceptions to this rule. For example, no gain was recognized on certain redemption distributions to corporate shareholders. Further, no gain was recognized on certain redemption distributions to noncorporate shareholders if the distributions were in partial liquidation of the distributing corporations. Finally, other exceptions to the general redemption rule applied to (1) certain distributions of the stock of controlled corporations, (2) certain distributions in redemption of stock to pay death taxes, (3) certain distributions to private foundations, and (4) certain distributions by regulated investment companies.

Finally, under prior law, if the general redemption rule applied, and gain was recognized to the distributing corporation, the rules requiring the recognition of gain on distributions of LIFO inventory and property subject to a liability in excess of basis did not apply.

Reasons for Change

Under a double tax system, corporate income generally is taxed twice. Such income is taxed first to the corporation that earns it. It

[10] For legislative background of the provision, see: H. R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 54; H. R. Rep. No. 98-432, Pt. 2 (March 5, 1984), p. 1189; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 36; S. Prt. 98-169, Vol. I (April 2, 1984), p. 176; and H. R. Rep. No. 98-861 (June 23, 1984), p. 819 (Conference Report).

is taxed a second time to the ultimate shareholders of such corporation when it is distributed to them. Any failure to treat distributions of appreciated property as taxable events to the distributing corporation, however, provided opportunities for deferring, or even avoiding, corporate level tax. The Congress believed that such a result was inappropriate under a double-tax system.

This result can be illustrated by a simple example. Assume that all of the stock of a corporation is owned by several individual shareholders. Further, assume that the shareholders wanted to realize the value in the appreciation of certain of the corporation's assets. If the corporation sold the assets and distributed the proceeds to the shareholders as a dividend, gain on the sale would have been taxed to the corporation. Further, the individual shareholders would have included the amount of the distribution in income. However, if instead the corporation distributed the assets to the shareholders in a transaction other than a redemption and, shortly thereafter, the shareholders sold the assets, no gain would have been recognized by the distributing corporation on the distribution, assuming that the transaction was respected for tax purposes. In such a case, a corporate level tax on the appreciation in value of corporate assets was avoided. Because of these rules, the treatment for Federal tax purposes of substantially equivalent transactions diverged.[11]

A corporate level tax on the appreciation in value of corporate assets generally could be deferred if the assets were distributed in an ordinary, nonliquidating distribution to a corporate shareholder. In essence, where appreciated property was distributed in an ordinary, nonliquidating distribution to a corporate shareholder, the liability for the tax on appreciation was generally shifted from the distributing corporation to the corporate shareholder. This deferral and shifting of tax liability occurred because, under prior law, generally no gain or loss was recognized by the distributing corporation and the corporate shareholder inherited the distributing corporation's basis in, and holding period for, the distributed property. Finally, because the character of the gain was probably determined by reference to the character of the property in the corporate shareholder's hands rather than in the hands of the distributing corporation, in some cases the character of the income might have been changed.

The Congress did not believe that it was appropriate to provide a rule in the case of distributions to corporate shareholders, even controlling corporate shareholders, different from the rule applicable in the case of distributions to individual shareholders. The theory of section 311 is that the distribution of appreciated property to a shareholder is a realization event and, therefore, an appropriate time to impose tax liability. There is no reason why this rule should not apply to nonliquidating transactions between related corporations. If 2 corporations are not filing consolidated Federal income tax returns, they should be treated as separate taxpayers,

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[11] Discontinuity was compounded if the distributions took the form of a redemption to which subpart A applied, including a redemption taxed to non-corporate shareholders as a dividend. In such a case, generally both the distributing corporation and the shareholders had a taxable event.

just as they are when 1 sells property to, or performs services for, the other. Further, the Congress was aware that there were several cases under prior law where the failure to tax currently the ordinary, nonliquidating distribution of appreciated property to a related corporate shareholder resulted in significant tax avoidance. For example, under prior law, an acquiring corporation could sell, indirectly, built-in-loss assets of an acquired corporation and recognize the loss while selling, indirectly, built-in-gain assets of the acquired corporation without having to take any of that gain into income. The Congress was also aware of transactions in which one corporation could purchase all of the stock of another, cause the acquired corporation to distribute appreciated property without recognizing gain, and then sell the stock and recognize a tax loss. The provision was intended in part to address these cases.

Explanation of Provision

Under the provision, gain (but not loss) is generally recognized to the distributing corporation on any distribution of appreciated property to which subpart A (sections 301 through 307) applies as if such property had been sold by the corporation for its fair market value.

There are several exceptions to this rule. First, gain is not recognized if the distribution is made with respect to qualified stock and (1) it qualifies as a partial liquidation under section 302(b)(4), or (2) it is a qualified dividend. Stock is qualified stock if it is held by a person (other than a corporation) who, after the application of attribution rules, and look-through rules in the case of certain pass-through entities, at all times during the lesser of the 5-year period ending on the date of the distribution, or the period during which the distributing corporation (or a predecessor corporation) was in existence, held at least 10 percent in value of the outstanding stock of the distributing corporation (or a predecessor corporation). A qualified dividend is a distribution of property taxable to the shareholder as a dividend if the property is (1) used by the distributing corporation immediately before the distribution in the conduct of a qualified trade or business, and (2) not described in section 1221(1) (relating to inventory and certain other property) or section 1221(4) (relating to certain accounts and notes receivable). (In this regard, it was intended that in a distribution of property described in either section 1221(1) or section 1221(4) and other property, available earnings and profits would be allocated first to the distribution of the property described in section 1221(1) or (4).) A qualified trade or business is a trade or business actively conducted throughout the 5-year period preceding the distribution which was not acquired by any person within such period in a transaction in which gain or loss was recognized in whole or in part.

For purposes of determining whether a distribution is a qualified dividend, earnings and profits generated by the distribution are to be taken into account. Thus, for example, assume that a corporation has no current or accumulated earnings and profits. Assume further that, after September 30, 1984, such corporation distributes property under subpart A to a noncorporate shareholder that, for more than 5 years, has held more than 10 percent in value of the outstanding stock of the distributing corporation. Finally, assume that the property, which at the time of the distribution had a fair market value of $2,000 and a basis to the distributing corporation of $1,000, was property used by the distributing corporation in the active conduct of a trade or business that had been actively conducted by the distributing corporation for more than 5 years and was not property described in section 1221(1) or (4). In such a case, under section 312, as amended by the Act, the distributing corporation's earnings and profits would be increased by $1,000 on the distribution. At the same time, the distributing corporation would be treated as having distributed that $1,000 of earnings and profits. Thus, in the example set forth above, the amount of the distribution would be $2,000 (i.e., the fair market value of the distributed property). The distribution would be treated as, in part, a qualified dividend and, in part, a distribution with respect to stock that does not qualify as a dividend.

In addition to the exception for qualified dividends, certain prior law exceptions are retained under the new rules. Under these exceptions, recognition is not required on (1) certain distributions of stock of controlled corporations, (2) certain distributions in redemption of stock to pay death taxes, (3) certain redemption distributions to private foundations, and (4) certain redemption distributions by regulated investment companies.

An example is illustrative.

Assume that: (1) X, a corporation, has one class of stock outstanding; (2) Y, an individual, owns, and has owned for over 5 years, 85 percent of the outstanding stock of X; (3) X, under subpart A, distributes to Y real property of a character subject to the allowance for depreciation under section 167; (4) at the time of the distribution the fair market value of the property was $2,000 and its basis to the distributing corporation was $1,000; (5) there was no recapture income to X under section 1245 or section 1250 on the distribution of the property; and (6) prior to the distribution the property was used by X in a trade or business acquired within 5 years of the distribution in a taxable transaction. In such a case, X would be treated as if it sold the property to Y. Gain would be recognized on the deemed sale under section 311. The distribution would not be a qualified dividend since the property distributed was used in a trade or business recently acquired by the distributing corporation in a taxable transaction. The amount of the gain would be the excess of the fair market value of the property ($2,000) over its basis to the distributing corporation ($1,000). Since Y owns more than 80 percent in value of the stock of X, X and Y are related persons for purposes of section 1239 and the $1,000 of gain recognized by X would be treated as ordinary income.

Under the Act, section 311(a) (relating to distributions of LIFO inventory) and section 311(c) (relating to liabilities in excess of basis) are to be applied before the new rules requiring the recognition of gain are applied. Thus, for example, assume that a corporation distributes LIFO inventory to a individual shareholder. Assume further that the LIFO inventory amount is $100, that the FIFO inventory amount is $125, and that the inventory is worth $120. The distributing corporation would have ordinary income of

$25. If the inventory is worth $130, the distributing corporation would have ordinary income of $30.

The Congress anticipated that the Treasury will promptly consider what changes, if any, are necessary or appropriate under the consolidated return regulations by reason of this rule. In general, the Congress anticipated that the distribution of appreciated property by 1 member of a group of corporations filing consolidated returns to another member would be treated as a deferred intercompany transaction.

Effective Dates

The provision generally applies to for distributions declared on or after June 14, 1984. However, there are a number of exceptions to this rule.

First, the new rules do not apply to a distribution to an 80-percent corporate shareholder that takes a basis in the distributed property determined under section 301(d)(2) if the distribution occurs prior to January 1, 1985. For this purpose, the term 80-percent corporate shareholder means, with respect to any distribution, any corporation which owns (1) stock in the distributing corporation possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote, and (2) at least 80 percent of the total number of shares of all other classes of stock of the distributing corporation (other than nonvoting stock which is limited and preferred as to dividends). It is intended that this exception be available only if the corporate shareholder qualifies as an 80-percent corporate shareholder both before and after the distribution. If the distributing corporation and the distributee corporate shareholder are members of an affiliated group that join in the filing of a consolidated Federal income tax return for the period which includes the date of the distribution, the aggregation rules of Treas. Reg. sec. 1.1502-34 are applicable in determining whether the 80-percent corporate shareholder exception applies.

Second, the new rules requiring recognition do not apply to a distribution prior to September 1, 1986, if (1) the distribution is to a corporation that joins with the distributing corporation in the filing of a consolidated Federal income tax return for the taxable year which includes the date of the distribution, (2) the distribution consists of qualified stock held (directly or indirectly) by the distributing corporation on June 15, 1984, (3) control of the distributing corporation (as defined in sec. 368(c) of the Code) is acquired after January 1, 1984, and before January 1, 1985, other than in a tax-free transaction, and (4) a tender offer for the shares of the distributing corporation was commenced on May 23, 1984, and amended on May 24, 1984. For purposes of this exception to the general effective date provision, the term qualified stock means stock in a corporation which on June 15, 1984, was a member of the affiliated group of corporations that joins with the distributing corporation in the filing of a consolidated Federal income tax return for the taxable year which includes June 15, 1984.

Third, the new rules do not apply to distributions made prior to February 1, 1986, of certain property held by certain corporations acquired by a common parent during the one-year period ending on February 1, 1984.

Finally, the new rules do not apply to certain distributions made prior to February 1, 1986, of interests in a publicly-traded partnership more than 80 percent of which was owned by the distributing corporation (or any member of an affiliated group of which the distributing corporation was a member) on March 7, 1984.

Revenue Effect

This provision, together with the provision relating to the holding period of property distributed by one corporation to another, is estimated to increase fiscal year budget receipts by $2 million in 1984, $14 million in 1985, $48 million in 1986, $101 million in 1987, $160 million in 1988, and $222 million in 1989.

6. Capital Gains Distributions From Regulated Investment Companies and Real Estate Investment Trusts (sec. 55 of the Act and secs. 852 and 857 of the Code)[12]

Prior Law

Generally, regulated investment companies ("RICs") that distribute their income are not subject to tax. Rather, that income is taxed directly to their shareholders.

RICs frequently realize long-term capital gain income. That income, if distributed, is generally treated as long-term capital gain to the shareholders. If the stock with respect to which a long-term capital gain distribution is made (or treated as having been made) is held by a shareholder for less than 31 days, any loss on the sale or exchange of that stock is treated as a long-term capital loss to the extent of any long-term capital gain distribution by the RIC with respect to such stock. Similar rules apply with respect to real estate investment trusts ("REITs").

Under these rules, a taxpayer may have been able to convert short-term capital gain into lower-taxed long-term capital gain by buying RIC or REIT stock immediately before the ex-dividend date of a long-term capital gain distribution, waiting 32 days, and then selling the stock.

Reason for Change

Congress determined that prior law offered too much of an opportunity to convert short-term capital gain to long-term capital gain. The 31-day holding period requirement was lengthened to discourage taxpayers from making tax-motivated purchases of RIC or REIT stock shortly before ex-dividend dates of capital gains distributions.

Explanation of Provision

If stock with respect to which a long-term capital gain distribution is made (or treated as having been made) by a RIC or a REIT is held by a shareholder for 6 months or less, any loss on the sale or exchange of the stock is treated as a long-term capital loss to the extent of the long-term capital gain distribution. To the extent provided in regulations, an exception is provided for dispositions of stock pursuant to a periodic redemption plan. In determining the period for which a taxpayer has held stock of a RIC or REIT, rules similar to those of section 246(c), as amended by the Act, apply.

[12] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 55; H.R. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1192-1193; Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 37; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 179-180; and H.R. Rep. No. 98-861 (June 23, 1984), pp. 823-824 (Conference Report).

Effective Date

The provision is applicable to losses incurred on stock or beneficial interests with respect to which the taxpayer's holding period begins after the date of enactment (July 18, 1984).

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $83 million in 1986, $89 million in 1987, $96 million in 1988, and $103 million in 1989.

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7. Certain Expenses Incurred in Connection With Short Sales (sec. 56 of the Act and secs. 163, 263, and 265 of the Code)[13]

Prior Law

Treatment of short sales of stock

In a "short sale," the taxpayer sells borrowed property (such as stock or securities) and later closes the short sale by returning identical property to the lender. Gain or loss on the closing of a short sale is considered gain or loss from the sale or exchange of a capital asset if the property used to close the short sale is a capital asset in the hands of the taxpayer. Where the property sold short is stock, and a dividend is distributed with respect to the stock, the taxpayer is required to pay an amount equal to the value of the distribution to the lender of the stock. The Internal Revenue Service ruled that this payment in lieu of a dividend is deductible currently against ordinary income. Rev. Rul. 72-521, 1972-2 C.B. 178; Rev. Rul. 62-42, 1962-1 C.B. 133.

When a dividend is paid with respect to stock, the stock can be expected to decline in value by an amount that approximates the value of the dividend distribution. Taxpayers could effectively convert ordinary income to capital gain by entering into a short sale of stock just before the ex-dividend date,[14] deducting the dividend-substitute payment against ordinary income, and realizing an offsetting capital gain upon closing the short sale.

When a taxpayer borrows property for use in a short sale, the taxpayer may receive a rebate fee—taxable as ordinary income—with respect to short sale proceeds deposited with the lender as collateral. This rebate fee compensates the taxpayer for the lender's use of the short sale proceeds during the period before the short sale is closed and property is returned.

Investment interest limitation

Section 163(d) limits deductions for interest by an individual or other noncorporate taxpayer on indebtedness to purchase or carry an investment. The deduction for investment interest is limited to the taxpayer's net investment income plus $10,000. Disallowed interest deductions are carried over and may be allowed in future years. Under prior law, short sale expenses were not treated as in-

[13] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 56; H. R. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1194-1195; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 41; S. Prt. 98-169, Vol. I (April 2, 1984), pp 181-182; Senate floor amendment, 130 Cong. Rec. S. 4433-4436 (April 12, 1984); and H. R. Rep. No. 98-861 (June 23, 1984), pp. 824-827 (Conference Report).

[14] The ex-dividend date is the date immediately after the day on which the shareholder must have purchased the stock to be entitled to receive the dividend.

terest for purposes of this limitation (although rebate fees were included in net investment income for purposes of the limitation).

Interest related to tax-exempt income

In general, section 265(2) provides that no deduction is allowed for interest on indebtedness incurred or continued to purchase or carry tax-exempt obligations.

In the case of a securities dealer who borrows money for the purpose of conducting a business that includes the holding of tax-exempt obligations, but whose borrowings cannot be traced to the purchase or continued holding of such obligations, section 265(2) is applied on the basis of an allocation. (See Rev. Proc. 72-18, 1971-1 C.B. 1; and *Leslie* v. *Commissioner*, 413 F.2d 636 (2d Cir. 1969), *cert. denied*, 396 U.S. 1007 (1970).) The amount of interest allocated to tax-exempt obligations is determined by multiplying the taxpayer's total interest expense by a fraction the numerator of which is the average adjusted basis of the tax-exempt obligations held during the taxable year and the denominator of which is the average adjusted basis of the total assets held during the year. Interest on debt that is traceable entirely to tax-exempt obligations and interest that is not subject to disallowance under section 265(2) is excluded from this computation. The Internal Revenue Service has ruled that section 265(2) does not apply to disallow interest deductions with respect to indebtedness that is collateralized by tax-exempt securities held for the accounts of customers and that the securities dealer is required to segregate pursuant to rules promulgated under the Securities and Exchange Act of 1934. Rev. Rul. 74-294, 1974-1 C.B. 71.

Under prior law, a short sale was not treated as a borrowing for purposes of section 265(2). It was unclear whether amounts (*e.g.*, rebate fees) paid by the lender of property used in a short sale, which amounts represent compensation for the use of money, were treated as interest.

Reasons for Change

The short sale transaction described above provided a means to avoid the limitations on the deductibility of capital losses through a scheme lacking substantial economic substance. Capital losses, whose deductibility against ordinary income is limited, could be deducted against the capital gain generated by the short sale. The transaction was also attractive to a taxpayer who had both long-term capital gain and short-term capital loss, because it effectively converted ordinary income to long-term capital gain.

In the case of large dividends, short sale transactions prior to ex-dividend dates were widely used to avoid tax. For example, Chrysler Corp. recently paid a large dividend on 10 million shares of preferred stock. At the time of the ex-dividend date, short sales of the preferred stock exceeded 6 million shares.

In many cases, costs incurred in a short sale for the use of property to produce investment income or exempt interest have the same function relative to such investment income or exempt interest as interest paid, the deduction of which is limited or disallowed under present law. Congress decided that the tax treatment of interest and short sale expenses should be clarified.

Explanation of Provision

Treatment of short sales of stock

Payments in lieu of dividends are not deductible unless the short sale is held open for at least 46 days (more than 1 year in the case of payments in lieu of extraordinary dividends, as defined for purposes of the provision that reduces a corporate shareholder's basis in stock by reason thereof). The amount disallowed as a deduction is required to be capitalized (*i.e.*, added to the basis of the stock used to close the short sale).

In determining whether the short sale is held open for the required 46-day (or more-than-1-year) holding period, there is not to be included any period during which the taxpayer holds, has an option to buy, or is under a contractual obligation to buy, substantially identical stock or securities, or diminishes the risk of loss from the short sale by reason of holding 1 or more other positions with respect to "substantially similar or related property" (as that term is defined for purposes of the holding-period requirements for the dividends received deduction).

In addition, except with respect to extraordinary dividends, the Act permits the deduction of dividend-substitute payments to the extent of ordinary income that is received from the person providing the stock used in the short sale as compensation for the use of collateral. To the extent that earnings on the collateral represent ordinary income, there is no conversion of ordinary income to capital gain.

The provision relating to short sale expenses applies before the application of section 263(g) (relating to interest and carrying costs in the case of straddles).

Investment interest

For purposes of the restriction on the deductibility of investment interest, the definition of interest is expanded to include any amount allowable as a deduction in connection with personal property used in a short sale.

Interest related to tax-exempt income

For purposes of the provision that disallows interest deductions related to tax-exempt income, with 1 exception, the definition of interest is expanded to include any amount paid or incurred in connection with personal property used in a short sale. In addition, the Act makes clear that section 265(2) applies to amounts paid by the person providing the personal property used in a short sale as compensation for use of collateral with respect to the property (*e.g.*, a rebate fee).

Section 265(2) will not apply to disallow a deduction for short sale expense if the taxpayer (1) deposits cash as collateral for the property used in the short sale, and (2) does not earn a material return on the cash so deposited. Thus, section 265(2) will not apply to disallow deductions for expenses incurred by investors who do not receive the short sale proceeds or a rebate fee. An example of a case to which 265(2) would apply is that of a taxpayer whose business includes buying and selling tax-exempt obligations, whose borrowings cannot be traced to such obligations, and who receives a rebate fee—calculated by reference to the broker call rate—with respect to the short sale proceeds. The Act contemplates, however, that the provision will not apply to a broker who acts as a conduit in a short sale executed for a customer.

Effective Date

The provision applies to short sales entered into after the date of enactment, in taxable years ending after such date.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $22 million in 1984, $32 million in 1985, $38 million in 1986, $43 million in 1987, $48 million in 1988, and $54 million in 1989.

8. Corporate Stock Warrants (sec. 57 of the Act and sec. 1032 of the Code)[15]

Prior Law

Prior to the Tax Reform Act of 1976, gain to the grantor of an option to buy property arising from the failure of the holder to exercise it, or its repurchase by the grantor, generally resulted in ordinary income to the grantor. In Rev. Rul. 72-198, 1972-1 C.B. 223, the Internal Revenue Service stated its position that the general rule applied with respect to warrants issued by a corporation to acquire its own stock, reasoning that warrants are a kind of option. Under the Service's position, a corporation had $2 of ordinary income if a warrant it issued for $2 lapsed without being exercised. Similarly, in some situations the Service allowed a corporation an ordinary loss deduction if it bought back warrants to acquire its own stock for more than it received upon their issuance.

The Service's position in Rev. Rul. 72-198 was arguably inconsistent with some old case law. For example, *Illinois Rural Credit Association* v. *Commissioner*, 3 B.T.A. 1178 (1926), held that subscription payments made to a corporation as a down payment on the purchase of stock of the corporation were not includible in the corporation's income when they were forfeited to the corporation. The transaction was viewed as capital in character.

Section 2136 of the Tax Reform Act of 1976 generally changed the rules applicable to options to buy property (sec. 1234). Under those rules, gain or loss to the grantor of an option from any closing transaction with respect to, and gain to the grantor on the lapse of, such an option is treated as short-term capital gain or loss. The legislative history of the those rules indicated that Congress was aware of, but took no position on, the question whether a corporation realized income when warrants to purchase its stock expired unexercised, or lapsed. However, the Service continued to adhere to its position that warrants should be treated like other options.

Section 1032 provides that a corporation recognizes no gain or loss on the receipt of money or other property in exchange for its stock. Furthermore, a corporation does not recognize gain or loss when it redeems its stock, with cash, for less or more than it received when the stock was issued.

[15] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 57; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1196; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 42; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 183; and H. Rep. No. 98-861 (June 23, 1984), p. 827 (Conference Report).

Reasons for Change

Congress believed that, under prior law, taxpayers may have been able to take 1 position if their warrants went down in value and a different position if they went up in value. For example, if a corporation were to issue a warrant for $2 and purchase it back for $1, it might have argued that, notwithstanding Rev. Rul. 72-198, it did not recognize any income, citing *Illinois Rural Credit Association* and other authorities. On the other hand, if the corporation's stock were to appreciate and the corporation were to purchase the warrant back for $3, it might have claimed a loss, citing Rev. Rul. 72-198. Congress intended to end this possible discontinuity and provide clear rules for the treatment of gain or loss to a corporation on any lapse or repurchase by the corporation of a warrant it issued to acquire its stock. The Congress believed that generally the lapse or repurchase of a warrant should not produce different tax consequences to the corporation than, for example, an exercise of the warrant followed by a repurchase by the corporation of the newly-issued stock.

Explanation of Provision

Under the Act, a corporation does not recognize gain or loss on any lapse or repurchase of a warrant it issued to acquire its stock.[16] The treatment under prior law of nonqualified employee stock options was not changed. Nor was the treatment of the holder of the warrant.

Effective Date

The provision is applicable to warrants acquired or lapsing after the date of enactment (July 18, 1984).

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by less than $5 million annually.

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[16] In the case of a repurchase of a warrant, the rule applies only with respect to the difference between the amount the warrant was originally issued for and the repurchase price. Thus, for example, if the warrant is "repurchased" with property, the corporation will generally recognize any appreciation in the value of that property.

9. Accumulated Earnings Tax (section 58 of the Act and secs. 532 and 535(b) of the Code)[17]

Prior Law

An accumulated earnings tax is imposed on corporations that are formed or availed of for the purpose of avoiding the income tax with respect to shareholders by permitting earnings and profits of the corporation to accumulate instead of being distributed. Where applicable, the tax is imposed at a rate of 27-1/2 percent on the first $100,000 of accumulated taxable income for the taxable year and at a rate of 38-1/2 percent on accumulated taxable income in excess of $100,000.

The fact that a corporation is a mere holding or investment company is *prima facie* evidence that such corporation was formed or availed of for the purpose of avoiding the income tax with respect to shareholders. In the case of other corporations, an accumulation of earnings and profits beyond the reasonable needs of the business establishes a rebuttable presumption of a tax avoidance purpose.

The term "accumulated taxable income" (ATI) means regular taxable income, with certain adjustments, reduced by a deduction for dividends paid and an accumulated earnings credit. In determining ATI, a corporation is permitted a deduction for regular income taxes. It is also permitted a deduction for net capital losses actually sustained during the year in question. (In contrast, a net capital loss is not allowed as a deduction against regular taxable income but can be carried back or forward as a deduction against capital gain). A deduction from ATI is also allowed for net capital gain during the year, determined without regard to capital loss carryovers or carrybacks, less certain taxes attributable to net capital gain.

Under prior law, there was some controversy regarding the application of the accumulated earnings tax to widely-held corporations. The Internal Revenue Service asserted that the tax could be imposed on widely-held corporations, even those not controlled by a few shareholders or groups of shareholders. The issue had not been resolved definitively by the courts. See, *Golconda Mining Corp. v. Commissioner*, 507 F.2d 594 (9th Cir. 1974). But see, *Trico Products Corp. v. Commissioner*, 137 F.2d 424 (2d Cir. 1943); *Trico Products Corp. v. McGowan*, 169 F.2d 343 (2d Cir. 1948); and Rev. Rul. 75-305, 1975-2 C.B. 228.

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[17] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, section 58; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1198; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, section 43; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 185; and H. Rep. No. 98-861 (June 23, 1984), pp. 828 (Conference Report).

Reasons for Change

The deduction from ATI for net capital loss was introduced in 1936. Presumably, its purpose was to permit a corporation to accumulate income in order to restore losses sustained in the course of its business. The Congress believed that while there may have been justification for the deduction in 1936, there is less justification today. As a result of a series of provisions enacted beginning in 1939, business losses are now very seldom treated as capital losses.

In particular, the Congress believed that the deduction from ATI for net capital loss was especially difficult to justify in the case of a mere holding or investment company. Allowing such a company to deduct net capital loss in computing its accumulated earnings tax was inconsistent with the treatment of regulated investment companies and real estate investment trusts. Special rules apply to those entities. In general, those entities can avoid corporate-level tax, but only by distributing a high percentage of their income annually. For this purpose, net capital loss is not allowed as a deduction in determining the amount of their income which must be distributed.

The Congress was aware that a rather elaborate scheme could have been utilized under prior law by investment companies to exploit the special deduction from ATI for net capital loss. Under this scheme, an investment company that did not elect, or did not otherwise qualify, to be taxed as a regulated investment company could be formed to accumulate dividend income and avoid the imposition, on itself or its shareholders, of more than a minimal amount in current taxes.

Generally, the investment company would be widely-held. Further, its assets would be invested primarily in dividend-paying stock so that, for the most part, its income would consist of dividends eligible for the 85-percent dividends received deduction. To the extent of slightly more than the remaining 15 percent of income, the investment company would have deductible expenses consisting of management fees, brokerage fees, interest, and other items. Consequently, it would have no regular taxable income. However, the 85 percent dividends received deduction would not shield it from the accumulated earnings tax because the dividends received deduction is added back to taxable income in computing ATI.

Initially, the investment company could have contended that, because it was widely-held, it was not subject to the accumulated earnings tax. If it was nominally subject to the accumulated earnings tax, it may have been able to avoid actual liability for the tax, in part by carefully structuring the timing of its capital gains and losses. For example, for a number of years it might have been able to arrange to realize sufficient capital loss to eliminate its ATI and, therefore, any accumulated earnings tax liability.

The investment company then might have been able to take all of its long-term capital gains in one year. Those capital gains would not have been subject to regular income tax to the extent that they were offset by the capital losses sustained in earlier years. Moreover, those capital gains for the most part would not have been subject to the accumulated earnings tax since, under the accumulated earnings tax, a deduction was also allowed for net capital gain (determined without regard to any capital loss carryovers). The allowance of a deduction for net capital losses in a prior year as well as a deduction for net capital gains in subsequent years (determined without regard to any capital loss carryovers), less attributable taxes, in determining accumulated taxable income effectively permitted the capital losses to be taken into account twice in computing ATI.

The Congress knew of no reason why widely-held companies should be automatically exempt from the accumulated earnings tax. Further, the Congress could not justify the deductions from ATI of both net capital losses and net capital gains (determined without regard to any capital loss carryovers), as permitted under prior law.

Explanation of Provision

While no inference was intended as to prior law, the Act provides that the mere fact that the stock of a corporation is widely-held does not exempt it from imposition of the accumulated earnings tax. This rule applies to operating companies as well as mere holding or investment companies. The Congress understood, however, that although the requisite tax avoidance purpose may be inferred in an appropriate case, it may be difficult, as a practical matter, to establish a tax avoidance purpose where the taxpayer is a widely-held operating company and no individual or small group of individuals has legal or effective control of the corporation.

In addition, under the Act, generally the deduction from ATI for net capital loss actually sustained during the taxable year remains, except as noted below. Further, generally the deduction from ATI for net capital gain, less attributable taxes, remains. Nor is any change made in the method of determining the attributable taxes. However, in determining the deduction for any taxable year from ATI for net capital gain, net capital loss for the prior taxable year is to be carried over and treated as a short-term capital loss. No such loss carryover is to be used more than once in determining the net capital gain deduction from ATI. The general effect of these rules is that the deduction from ATI for net capital gain is reduced by reason of net capital loss allowed as a deduction against ATI for a prior year.

The deduction against ATI for net capital loss actually sustained during the taxable year is subject to reduction. The general effect of the reduction rule is that the deduction from ATI for such net capital loss is reduced by reason of net capital gain allowed as a deduction from ATI for a prior year. In general, the reduction is equal to any deduction from ATI, for preceding taxable years beginning after the date of enactment of the Act (July 18, 1984), for net capital gain, less attributable taxes. However, in no event is the same net capital gain to be used more than once in reducing a deduction from ATI for net capital loss.[18] If the corporation's accu-

[18] To the extent any net capital loss actually sustained during the taxable year is reduced under this paragraph, the Congress did not intend that it be treated as a capital loss carryover for purposes of the preceding paragraph.

mulated earnings and profits as of the close of the preceding taxable year are less than the reduction that would otherwise be made for a taxable year, the reduction for that taxable year is to be limited to the amount of such accumulated earnings and profits.

The rule that capital loss carrybacks and carryovers do not themselves reduce ATI remains.

A number of different rules are provided for mere holding or investment companies, as that term is used under the accumulated earnings tax provisions. First, they are allowed no deduction from ATI for the year's actual net capital loss. Second, no net capital loss carryover is to reduce the deduction against ATI for net capital gain. Third, a deduction for net short-term capital gain is allowed, but only to the extent of any previously unused capital loss carryovers under section 1212 to the year in question. This rule prevents a mere holding or investment company from incurring accumulated earnings tax liability solely as a result of having capital losses in a prior year followed by a short-term capital gain in the same amount in a later year. Fourth, for all purposes of subchapter C (section 301 through section 386), accumulated earnings and profits are not to be less than they would have been had section 535(b), as amended by the Act, applied to the computation of earnings and profits for all taxable years beginning after the date of enactment.

A simplified example is illustrative.[19]

Assume that X is a mere holding or investment company and that the applicable tax rate on net capital gain is 28 percent. In year 1, X has no taxable income or loss, after availing itself of a dividends received deduction of $60,000, and it has a long-term capital loss of $60,000. In year 2, X has long-term capital gain of $110,000 and no other taxable income or loss, after availing itself of a $60,000 dividends received deduction. As a result of the capital loss carryover from year 1, X's taxable income in year 2 would be $50,000 and its regular income tax liability would be $14,000. Under prior law, X would have had no ATI in year 1 because the $60,000 in dividends received deduction (added as an adjustment to taxable income in computing ATI) would have been offset by the $60,000 capital loss (subtracted as an adjustment to taxable income in computing ATI). In year 2, X would have had ATI of $60,000, consisting of taxable income determined without regard to any capital loss carryover ($110,000), plus the dividends received deduction ($60,000), minus regular taxes ($14,000), minus the year's actual net capital gain ($110,000), plus attributable taxes ($14,000). On the other hand, had all the events described above occurred in a single taxable year, under prior law, X's ATI would have been $120,000, consisting of taxable income ($50,000), plus the dividends received deduction ($120,000), minus regular taxes ($14,000), minus net capital gain ($50,000), plus attributable taxes ($14,000).

Under the Act, X's ATI in year 1 is $60,000, consisting of taxable income (none) plus the dividends received deduction ($60,000). X's ATI in year 2 is $60,000, consisting of taxable income determined without regard to any capital loss carryover ($110,000), plus the dividends received deduction ($60,000), minus regular taxes of 28

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[19] The example ignores the effect of the accumulated earnings credit and section 246(b), which limits the aggregate dividends received deduction.

percent of \$50,000 (\$14,000), minus the year's actual net capital gain (\$110,000), plus attributable taxes (\$14,000). Had all the events described occurred in a single taxable year, under the Act ATI would be \$120,000, consisting of taxable income (\$50,000), plus the dividends received deduction (\$120,000), minus regular taxes (\$14,000), minus net capital gain (\$50,000), plus attributable taxes (\$14,000).

Effective Date

The provision applies to all taxable years beginning after the date of enactment (July 18, 1984).

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by \$62 million in 1985, \$78 million in 1986, \$33 million in 1987, \$35 million in 1988 and \$36 million in 1989.

10. Exchange of Stock for Debt (sec. 59 of the Act and sec. 108 of the Code)[20]

Prior Law

Under prior law, income was realized when indebtedness was forgiven or in other ways cancelled (sec. 61(a)(12)). For example, if a corporation issued bonds at par and later repurchased the bonds at less than par, the difference was taxable at that time. Prior law (sec. 108) provided that income from the discharge of indebtedness of a corporation may be excluded from income if the corporation reduced the basis in depreciable property. This allowed the corporation to, in effect, defer the income. Special rules applied to title 11 (bankruptcy) cases and to corporations which were insolvent.

Cases have held that there is an exception to the rule for income on discharge of indebtedness where a corporate debtor issues its own stock to cancel its indebtedness.[21] This exception was grounded on the theory that the stock was simply a substitute liability for the debt and that no event had occurred which should cause the recognition of income. However, the exception was applied notwithstanding the fact that the stock may be substantially different than the debt obligation, or that the value of the stock issued was substantially less than the debt cancelled.

Reasons for Change

Under prior law, a corporation was treated differently where it issued stock to discharge its debts than where it raised new capital by a stock issuance and used that capital to discharge its outstanding debts. The latter case would have given rise to income from the discharge of indebtedness. Prior law also allowed a corporation which retired existing indebtedness for stock and then issued new indebtedness with a lower principal amount and a higher interest rate to obtain a larger interest deduction, notwithstanding that total debt payments (principal and interest) may have remained unchanged.

For these reasons, the Congress believed that the so-called "stock-for-debt" exception should generally be repealed, for solvent corporations outside of a title 11 proceeding.

Explanation of Provision

The Act treats a corporation which issues stock in cancellation of its debt in the same manner as if it had satisfied the indebtedness

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[20] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 59; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1201-1202; and H. Rep. No. 98-861 (June 23, 1984), pp. 829-830 (Conference Report).

[21] See, for example, *Motor Mart Trust* v. *Comm'r*, 156 F.2d 122 (1st Cir. 1946).

with an amount of money equal to the fair market value of the stock. Thus, the corporation will have income from the discharge of indebtedness to the extent the principal of the debt exceeds the value of the stock (and other property transferred, if any). This rule applies where the principal amount of a corporate debt is discharged, including by reason of the exercise of a conversion right by the holder of the debt. It does not apply where payments are simply deferred. (Section 1032 does not prevent the recognition of this income from the discharge of indebtedness.)[22]

The repeal of the stock-for-debt exception does not apply if the discharge occurs pursuant to a title 11 (bankruptcy) case or to the extent the debtor is insolvent; in these cases, prior law continues to apply.

The repeal of the stock-for-debt exception also does not apply (and prior law will continue to apply) to debt discharge income under a "workout" where (1) the transfer of stock is made (pursuant to a plan) because of cash flow and credit problems which will cause the debtor corporation difficulty in meeting its liabilities during the next 12 months to such an extent that there is a substantial threat of an involuntary bankruptcy or insolvency proceeding, (2) the corporation notifies its stockholders of this financial difficulty and that it is engaged in a workout, (3) at least 25 percent of the total debt of the corporation is extinguished by transfers of stock pursuant to the plan, and (4) holders of more than 50 percent of the total indebtedness of the debtor corporation outstanding on the date of transfer approve the plan. The workout definition will be satisfied only if it is reasonably related to the objective of avoiding a likely insolvency or bankruptcy proceeding.

Effective Date

The provision generally will apply to transfers or stock issuances after the date of enactment (July 18, 1984).

The "workout" exception will become effective on the date on which the amendments made to section 382 by the Tax Reform Act of 1976 become effective (i.e., January 1, 1986). This delayed effective date was adopted to allow the Congress to consider the appropriate treatment of stock-for-debt exchanges in the case of financially troubled corporations while the Congress is reexamining generally the treatment of net operating loss limitations. A stock-for-debt exchange in the case of a financially troubled corporation is a change of ownership event which the Congress may decide is an appropriate occasion for the reduction of net operating losses either under rules of a revised section 382 or by reason of the creation of income from the discharge of indebtedness. It is anticipated that any reconsideration of the exceptions to stock-for-debt rules will include consideration of the rules relating to the use of preferred or limited stock, stock of a parent corporation, and stock of a party to a reorganization, and related technical issues.

In addition, the Act contains several transitional rules. Under the first transitional rule, the provisions in the Act will not apply

[22] Also, see section 108(e)(6) for treatment of the debtor corporation where debt is acquired as a contribution to capital by a shareholder.

to any transfer pursuant to a written binding contract or option (including a convertible debenture) which was in effect at all times on the day of June 7, 1984, and which remains in effect at all times thereafter. Thus, the provision applies to transfers pursuant to contracts or options entered into on or after June 7, 1984, since in such a case, the contract or option will not have been in effect at all times on June 7, 1984. This exception will apply only if the holder of the debt on June 7, 1984, also was the party to the contract or held the option on that date. A transfer pursuant to a written contract must be completed before January 1, 1985. The conversion of debt pursuant to an option or conversion right outstanding at all times on June 7, 1984, and thereafter will be covered by the transitional rule regardless of whether conversion is after 1984. Under the second transitional rule, the provision in the Act will not apply to a transfer of stock before January 1, 1985, to a corporation which owned at least 75 percent of the stock of the debtor corporation on June 7, 1984, and which owns more than 80 percent of the stock of that corporation after the transfer. Finally, a transfer before January 1, 1985, pursuant to a debt restructuring agreement entered into in November, 1983, for which a registration statement was filed with the Securities and Exchange Commission on March 7, 1984, will not be subject to these rules.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by less than $5 million annually.

11. Affiliated Groups (sec. 60 of the Act and sec. 1504 of the Code)[23]

Prior Law

In general, an affiliated group of corporations has the privilege of filing consolidated Federal income tax returns. One of the reasons corporations choose to file consolidated returns is to permit one corporation to make use of tax benefits (e.g., net operating losses and tax credits) generated by another corporation under circumstances in which the corporation generating the benefits cannot use them. Once a group commences filing such returns, it must generally continue to do so.

Under prior law (sec. 1504), the term "affiliated group" was defined to mean 1 or more chains of includible corporations connected through stock ownership with a common parent which was an includible corporation if (1) stock possessing at least 80 percent of voting power of all classes of stock and at least 80 percent of each class of the nonvoting stock of each includible corporation (except the common parent) was owned, directly, by 1 or more other includible corporations, and (2) the common parent owned, directly, at least 80 percent of the voting power of all classes of stock and at least 80 percent of each class of nonvoting stock of at least one of the other includible corporations. The term "includible corporation" was defined, in general, to mean any domestic corporation.[24]

For purposes of determining whether these requirements were satisfied, nonvoting stock which was limited and preferred as to dividends was disregarded. Further, employer securities (within the meaning of sec. 409A(l)) were disregarded while held under a tax credit employee ownership plan. Finally, qualifying employer securities (within the meaning of sec. 4975(e)(8)) were not taken into account while held under an employee stock ownership plan meeting the requirements of section 4975(e)(7).

Reasons for Change

Under prior law, section 1504(a) was intended to insure that 2 corporations be permitted to file consolidated returns and, in effect, be treated as 1 corporation for some tax purposes, only if 1 corporation had an 80-percent interest in the other. The Congress was

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[23] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 61; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), p. 1205; Senate floor amendment, 130 Cong. Rec. S. 4295 (April 11, 1984); and H. Rep. No. 98-861 (June 23, 1984), p. 831 (Conference Report).

[24] Specifically, the term "includible corporation" was defined to mean any corporation except (1) corporations exempt from taxation under section 501; (2) insurance companies subject to taxation under section 802 or 821; (3) foreign corporations; (4) corporations with respect to which an election under section 936 is in effect for the taxable year; (5) corporations organized under the China trade Act; (6) regulated investment companies and real estate investment trusts; and (7) DISCs or former DISCs.

aware that, notwithstanding the intent of the provision, corporations were filing consolidated returns under circumstances in which a parent corporation's interest in the issuing corporation accounted for less than 80 percent of the real equity value of such corporation. Further, the Congress was aware that this may have permitted certain unwarranted tax benefit transfers. The amendments contained in this section of the Act were designed to limit the extent to which taxpayers can accomplish such transfers and, in general, to prescribe a sounder definition of the term "affiliated group" for all Code purposes.

For example, under prior law, if a corporation (the loss corporate partner) which was not itself in a position to use tax losses or credits (e.g., a foreign corporation not otherwise engaged in an active trade or business in the United States) was interested in entering into a new venture which was expected to generate tax losses or credits, such corporation could have joined with a corporate partner (the profitable corporate partner) that was in a position to use the tax benefits. In such event, the venture could have been incorporated with a capital structure consisting of two classes of common stock. The first, Class A, would have been a normal common stock. The other, Class B, would have been a normal common stock except that it would have had only minimal voting rights and would have been convertible at a specified date into Class A common stock in a ratio permitting it to obtain 80-percent voting control. The profitable corporate partner would have acquired all the Class A stock for $400, and the loss corporate partner would have acquired all the Class B stock for $1,600. Because of the differences in voting rights, the Class A stock would have possessed 80 percent of the voting power of all classes of stock of the newly-incorporated venture. The incorporated new venture and the profitable corporate partner would have filed consolidated returns, even though the profitable corporate partner would have owned substantially less than 80 percent in value of the venture and even though the Class B stock would have been convertible into Class A stock. Generally, the ability of the Service successfully to attack such a case was uncertain.

Other devices might have been used under prior law in an attempt to produce a similar result. For example, the venture might have issued a carefully-written convertible preferred stock or warrants to the loss partner instead of a convertible Class B common stock.

Another transaction that prior law may have permitted involved a loss corporation common parent and a wholly-owned profitable subsidiary filing consolidated returns. The common parent may have capitalized the subsidiary with 2 classes of common stock equal in every respect except that 1 class had only nominal voting power. If the common parent sold the class of stock of the subsidiary having only nominal voting rights to unrelated third parties, the common parent and the subsidiary may have been able to continue filing a consolidated return even though the common parent may no longer have owned 80 percent of the subsidiary's real equity value. In such a case, the common parent's tax losses would offset the subsidiary's taxable income, and the unrelated third

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party purchasers could have ended up owning stock in a corporation earning income not subject to tax.

Explanation of Provisions

Affiliated group

Under the Act, the definition of the term "affiliated group" is amended for all purposes of subtitle A. Under the amended definition, 2 corporations do not qualify as an affiliated group (and, among other things, are therefore not eligible to elect to file, or continue to file, a consolidated return) unless 1 owns, directly, stock (1) possessing at least 80 percent of the total voting power of all classes of stock, and (2) having a fair market value equal to at least 80 percent of the total value of all outstanding stock, of such other corporation. For this purpose, as described below, certain preferred stock is to be disregarded. Similar rules apply in determining whether any other corporation is, or continues to be, a member of the group.[25]

No inference regarding the application of prior law was intended. However, this rule is not intended to overturn the position set forth in Rev. Rul. 78-119, 1978-1 C.B. 277, holding that a corporation which has been a member of a group filing a consolidated return is not deconsolidated merely because its parent has temporarily lost its power to vote such corporation's stock by virtue of a court order issued during the pendency of litigation.

Preferred stock and employer securities

As stated above, certain stock is to be disregarded in testing for affiliated group status. The stock to be disregarded is stock which (1) is not entitled to vote, (2) is limited and preferred as to dividends and does not participate in corporate growth to any significant extent, (3) has redemption and liquidation rights that do not exceed the stock's paid-in capital and/or par value[26] (except for a reasonable redemption premium), and (4) is not convertible into any other class of stock. Under this rule, preferred stock carrying a dividend rate materially in excess of a market rate when issued may not be disregarded.

The rule of prior law that certain employer securities would be disregarded in testing for affiliated group status was repealed.

Consolidation after deconsolidation

Consolidation after deconsolidation is restricted. In general, if a corporation is included in a consolidated return filed by an affiliated group for a taxable year which includes any period after December 31, 1984, and such corporation ceases to be a member of

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[25] Under section 332, if 1 corporation completely liquidates, generally no gain or loss is recognized to a corporate shareholder which owns stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote, and at least 80 percent of the total number of shares of all other classes of stock (other than nonvoting stock which is limited and preferred as to dividends), of the liquidating corporation. The stock ownership requirement of section 332 is thus at least substantially similar to section 1504 under prior law. A technical amendment will be recommended conforming section 332, and perhaps other sections, to new section 1504.

[26] If the stock's paid-in capital and/or par value does not reflect its fair market value upon issuance, it may be more appropriate to compare the stock's redemption and liquidation rights to that value rather than to paid-in capital and/or par value.

such group for a taxable year beginning after December 31, 1984, then such corporation (and any successor) may not be included in any consolidated return filed by that group or any other group having the same common parent (or a successor) before the 61st month after the cessation.

The Treasury is authorized to waive the rule prohibiting consolidation after deconsolidation for any period subject to such conditions as the Treasury may prescribe. The rule is an anti-abuse rule, and it is anticipated that it will be applied by reference to its purposes. For example, assume that operating corporation A owns all the stock of operating corporation X and that the two file a consolidated return. On July 1, 1986, A merges into unrelated operating corporation B in a transaction qualifying under section 368(a)(1)(A). Assume that the transaction is not a reverse acquisition. Absent other factors, X should be able to join in filing a consolidated return with the group of which B is the common parent for the period beginning July 1, 1986, and regulations should so provide.

Regulations

Regulatory authority is granted to the Treasury to disregard transfers of stock within an affiliated group in determining whether affiliated group status is broken. For example, assume that corporation A owns 100 percent of the only class of stock of corporation B, and corporation B owns 100 percent of the only class of stock of corporation C. It is contemplated that a transfer by A of 30 percent of the stock of B to C will not break the status of A, B, and C as an affiliated group. Further, Treasury is granted authority to prescribe regulations under which inadvertent, small changes in relative values of different classes of stock are to be disregarded in determining whether affiliated group status continues. Similarly, authority is provided to prescribe regulations permitting affiliated group status if there was reliance on a good faith but erroneous determination of value.

Authority is also provided for the Secretary to prescribe regulations necessary or appropriate to carry out the purposes of the provision including, but not limited to, regulations: (1) which treat warrants, obligations convertible into stock, and other similar interests as stock, and stock (like "puttable" stock) as not stock; and (2) which treat options to acquire or sell stock as having been exercised. Thus, for example, assume that corporation A's common stock is worth $40 a share. Assume further that corporation B, the owner of all of A's common stock, grants corporation C an option to acquire that stock for $20 a share at a date beginning 3 years from the date of the grant. The facts indicate that A and C are likely to be loss corporations but that B is profitable. If it can reasonably be expected that C will exercise the option, the regulations may, for purposes of the new provision, treat the option as having been exercised. Finally, the Treasury is authorized to prescribe regulations under which changes in voting power may be disregarded to the extent such changes are disproportionate to related changes in value. In general, it was not intended that these regulations adversely affect transactions which occurred prior to June 22, 1984.[27]

[27] See 130 Cong. Rec. S. 8410 (daily ed. June 27, 1984) (statement of Sen. Dole).

Effective Date

Except as provided below, the provision is effective for taxable years beginning after December 31, 1984.

Under a transitional rule, the provision does not generally apply to determine whether a corporation validly included in a consolidated return of an affiliated group under prior law for its taxable year which includes June 22, 1984, continues to be a member of such group until its first taxable year beginning after December 31, 1987. However, if (1) at any time after June 22, 1984, more than a de minimis amount of stock (generally as determined under the new rules) of any such corporation is sold or exchanged (including by redemption), or such corporation issues more than a de minimis amount of stock (generally as determined under the new rules) other than in the ordinary course of its business, and (2) thereafter, the new requirements for affiliated-group status are not satisfied (even though before December 31, 1987), then the new rules will apply to such corporation for its first taxable year beginning after December 31, 1984, or if later, the date such stock is sold, exchanged, or issued, as the case may be. For purposes of this rule, generally stock issued to employee stock ownership plans, stock issued upon the exercise of employee stock options, stock issued in connection with a stock split, and similar issuances of stock are to be treated as issuance in the ordinary course of the corporation's business. The Congress did not intend that this rule, which renders the transitional rule inapplicable in certain cases, apply unless, after the sale, exchange or issuance, the corporate shareholder owns a smaller percentage of the value of the issuing corporation's stock than it did before such sale, exchange, or issuance.

For example, assume that Corporation B has only 300 shares of class A common stock and 100 shares of class B common stock outstanding. Shares of each class are identical except that each share of class A common stock has three votes whereas each share of class B common stock has one vote. Corporation A owns all the class A common stock (which represents 90 percent of the voting stock and 75 percent of the value of all the stock of Corporation B) at all times during 1984, and Corporation C owns the balance of B's outstanding stock. Assume that A and B file a valid consolidated return for calendar year 1984. On June 30, 1985, A sells 20 shares of the class A common stock of B to a third party. After the sale, A owns stock possessing 84 percent of B's voting power and 70 percent of B's value. B would be disaffiliated under the provision as a result of the sale. Disaffiliation would not occur, however, if, instead, A bought any B stock from C or C sold its B stock to an unrelated party.

There is a limited exception to the rule denying the benefits of the transitional rule for corporations that issue or sell stock after June 22, 1984. Under this limited exception, the transitional rule continues to apply if the stock is issued or sold pursuant to a registration statement filed with the Securities and Exchange Commission on or before June 22, 1984 (even if amended thereafter), and immediately after the issuance or sale, and at all times thereafter until the first day of the first taxable year beginning after December 31, 1987, the requirements of section 1504(a) as amended by the

Act are satisfied, substituting 50 percent for 80 percent. It is intended that this exception be available, and that the protection of the transitional rule be retained, only if the issuance or sale is pursuant to a registration statement other than a so-called "shelf" registration statement filed pursuant to 17 C.F.R. sec. 230.415(a)(1)(x) (relating to securities to be offered on a continuous or delayed basis).

The Congress did not intend that corporations acquired after December 31, 1984, by other corporations that are included in consolidated returns for taxable years beginning after December 31, 1984, by virtue of the transitional rule, be excluded from the affiliated group which includes the acquiring corporation and its common parent, so long as the ownership of stock of the acquired corporation satisfies the new rule. For example, assume that P corporation and S corporation join in the filing of a valid consolidated return under the transitional rule described above for the 1984 calendar year with P as the common parent. Also assume that, but for the transitional rule, they would not be part of the same affiliated group under the provision. Assume further that P's ownership in S does not change. If, during calendar year 1986, S acquires all of the outstanding stock of T corporation, T would be permitted to join with P and S in the filing of the consolidated return for the balance of 1986 and 1987. The answer would be otherwise if the T stock acquired by S possessed less than 80 percent of the voting power or real equity value of T.

Questions arise regarding the application of the transitional rule to corporations that are validly included in a consolidated return of an affiliated group under prior law for the taxable year which includes June 22, 1984, and that also satisfy the requirements for affiliated group status under the new rules. It was not intended that for taxable years beginning after December 31, 1984, and before January 1, 1988, such corporations must continue to meet the prior law requirements for affiliated group status to avoid disaffiliation. For example, assume that X corporation and Y corporation are calendar year taxpayers, that Y has issued only one class of stock, and that at all times during 1984, X owns 100 percent of the outstanding shares of such stock. Assume further that in 1985, Y issues a new class of nonvoting common stock and that all shares of such stock are acquired by an unrelated party. Assume further that, thereafter, X still owns 80 percent of the voting power and value of Y stock so that X and Y would satisfy the requirements for affiliated group status under the new rules. The Congress did not intend that X and Y be disaffiliated, even if X and Y no longer satisfied the requirements of prior law. In this regard, a technical amendment may be appropriate.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $5 million in 1985, $20 million in 1986, $39 million in 1987, $39 million in 1988, and $19 million in 1989.

12. Earnings and Profits (sec. 61 of the Act and sec. 312 of the Code)[28]

Prior Law

Distributions by corporations to shareholders are generally included in income by the shareholders as dividends (and taxed at ordinary income rates) only to the extent such distributions are out of current or accumulated earnings and profits. Distributions in excess of earnings and profits are treated as a return of capital and reduce a shareholder's basis in his or her stock. Distributions in excess of basis and not out of earnings and profits are treated as gain from the sale or exchange of stock.

In general, a corporation's earnings and profits are intended to be a measure of the earnings of the corporation available for distribution to its shareholders. Under prior law, however, a corporation's earnings and profits often were substantially less than its economic income.

Under prior law, earnings and profits were reduced on a distribution by a corporation in a redemption of shares of its own stock in an amount equal to the excess of the amount of the distribution over the amount "properly chargeable" to the corporation's capital account. In applying this rule, some cases held, and the IRS eventually ruled, that a corporation's capital account was an amount equal to the par value of its stock plus the amount, if any, of paid-in surplus. See, e.g., *Jarvis* v. *Commissioner*, 43 B.T.A. 439, *aff'd.*, 123 F.2d 742 (4th Cir. 1941); and Rev. Rul. 79-376, 1979-2 C.B. 133.

Reasons for Change

Under prior law, a corporation's earnings and profits did not necessarily reflect its economic income. For example, under prior law, an oil and gas corporation could reduce its earnings and profits each year by the amount it deducted from taxable income for intangible drilling costs even though the expenditures resulted in the creation of an asset with a useful life well in excess of 1 year. Similarly, the rules for computing a corporation's earnings and profits failed to reflect economic income in the case of a sale of an appreciated asset in exchange for an installment obligation. If the selling corporation reported the gain on the installment method, its earnings and profits would be increased in the year of sale and in subsequent years by an amount equal only to the portion of the realized gain that was recognized in such year.

As a result of the above differences between earnings and profits and economic income, as well as a number of other such differ-

[28] For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 47; S. Prt. 98-169, Vol. I (April 2, 1984), p. 197; and H. Rep. No. 98-861 (June 23, 1984), p. 835 (Conference Report).

ences, a distribution by a corporation to its shareholders that was a dividend under state law could be treated as a return of capital for tax purposes. The Congress believed that when this occurred, a corporate tax preference or other benefit was, in effect, being passed through to shareholders and providing shareholders with an unintended tax benefit. Therefore, the Act contains a number of provisions designed to ensure that a corporation's earnings and profits more closely conform to its economic income.

Also, as described above, in the case of a distribution in redemption of the distributing corporation's stock, the distributing corporation's capital account was reduced in proportion to the amount of stock that was redeemed, with such corporation's earnings and profits reduced by the excess of the amount of the distribution over the amount charged to the capital account. As a result, a distribution in redemption of the distributing corporation's stock taxable to the shareholder as capital gain might have offset more than a proportionate share of the earnings and profits of the distributing corporation without generating any dividend income. The Congress believed that this was an inappropriate result and that earnings and profits should be reduced only in proportion to the shares of stock that are redeemed.

Explanation of Provisions

Construction period interest, taxes, and carrying charges

For purposes of computing a corporation's earnings and profits, construction period carrying charges are required to be capitalized as a part of the asset to which they relate and written off as is the asset itself. This rule applies to all corporations, and it applies with respect to both residential and nonresidential real property and to personal property.

For purposes of this provision, the term "construction period carrying charges" means all (1) interest paid or incurred on indebtedness incurred or continued to acquire, construct, or carry property, (2) property taxes, and (3) similar carrying charges, to the extent that such interest, taxes, or charges are attributable to the construction period for such property and would be allowable as deduction for the taxable year in which paid or incurred (determined without regard to section 189).

The definition of the term "construction period" for corporations is the same as under section 189 (determined without regard to any real property limitation). Thus, the construction period commences with the date on which the construction (of real or personal property) begins and ends on the date the property is ready to be placed in service or is ready to be held for sale.

It is anticipated that regulations will be issued providing for the allocation of expenditures to the construction period and among different properties. It is anticipated that these regulations will adopt rules similar to those contained in Financial Accounting Standards Board Statement Number 34, as amended. Under those rules, for example, the amount of interest to be capitalized is the portion of the total interest expense incurred during the construction period that could have been avoided if funds had not been expended for construction. Interest expense that could have been avoided includes interest costs incurred by reason of additional borrowings to finance construction and interest costs incurred by reason of borrowings that otherwise could have been repaid with funds expended for construction.

This provision is applicable to the effect on earnings and profits of amounts paid or incurred in taxable years beginning after September 30, 1984.

Intangible drilling costs and mine development costs

Intangible drilling costs allowable as a deduction under section 263(c), and mineral exploration and development costs allowable as a deduction under sections 616(a) or 617, are required to be capitalized for purposes of computing earnings and profits, but only if the expenditures give rise to the creation of an asset having an anticipated economic life of more than 1 year. Intangible drilling costs capitalized under the provision are to be allowed as a deduction ratably over a 60-month period beginning with the month in which the production from the well begins. Mineral exploration and development expenses are to be allowed as a deduction ratably over the 120-month period beginning with the later of (1) the month in which the production from the deposit begins, or (2) the month in which the amount is paid or incurred.

Unamortized intangible drilling expenses incurred in connection with the drilling of a well are to be deducted in computing earnings and profits when it has been determined that the well is dry. (If a group of wells are drilled from a common drilling rig, drilling expenses are to be deducted in computing earnings and profits when it has been determined that the wells are dry.) Unamortized mineral exploration and development expenses incurred in connection with a mineral property are to be deducted in computing earnings and profits when the property is abandoned.

This provision is applicable to the effect on earnings and profits of amounts paid or incurred in taxable years beginning after September 30, 1984.

Certain trademark, trade name, and other expenditures

Amounts amortized under sections 173 (relating to circulation expenditures), 177 (relating to trademark and trade name expenditures), and 248 (relating to organizational expenditures) are to be capitalized and treated as part of the basis of the asset to which they relate. Expenditures made in connection with property having a reasonably determinable useful life are to be recovered for earnings and profits purposes over such useful life. No amortization deduction is allowed for expenditures made in connection with property which does not have a reasonably determinable limited useful life.

This provision is applicable to the effect on earnings and profits of amounts paid or incurred in taxable years beginning after September 30, 1984.

Certain distributions of appreciated property

In the case of a distribution of appreciated property by a corporation (other than an obligation of such corporation) to a shareholder with respect to stock, in a distribution to which subpart A (sections

301 through 307) applies, earnings and profits of the distributing corporation are to be increased by the amount of gain on the distributed property that is realized by the distributing corporation on the distribution, whether or not such gain is recognized.

Under sections 312(a)(3) and 312(c)(3) of prior law, a distribution of appreciated property by a corporation reduced its earnings and profits by an amount equal to the adjusted basis of the property to the corporation increased by any gain recognized to the corporation on the distribution. In a case to which the new provision applies, the Congress intended that earnings and profits be reduced by an amount equal to the distributing corporation's adjusted basis in the property increased by any gain realized by the distributing corporation on the distribution. A technical amendment may be appropriate to effectuate that intent.

The provision generally is applicable to the effect on earnings and profits of distributions made after September 30, 1984.

Under another provision of the Act,[29] the circumstances in which a distributing corporation can avoid recognition of gain on a distribution to its shareholders to which subpart A applies are substantially narrowed. That provision generally applies with respect to distributions declared on or after June 14, 1984. However, a number of transitional rules are provided. These transitional rules also apply for purposes of this provision.

Changes in LIFO reserves

In general, earnings and profits are to be increased or decreased by the amount of any increase or decrease in the LIFO reserve or recapture amount (determined under section 336(b)(3)). The provision is designed to eliminate the impact of LIFO on earnings and profits. Under prior law, if a corporation's LIFO reserve increased by $10, taxable income and earnings and profits were lower than they would have been had LIFO not been used. Under the new rules, $10 would be added to earnings and profits.

It is anticipated that under regulations an exception will be provided for decreases below the amount of the LIFO reserve as of the close of the taxable year of the corporation preceding the first taxable year to which the provision applies. Since the cumulative effect of a corporation's LIFO reserve has been to keep earnings and profits lower than they otherwise would have been, it is contemplated that the regulations will provide that in the event of a reduction in the LIFO reserve below its level as of the close of such taxable year (the pre-enactment reserve), earnings and profits will be increased as under prior law without any offsetting reduction under the new rules. However, because a reduction in the reserve below the pre-enactment reserve results in an increase in taxable income and earnings and profits, any subsequent restoration of the reserve up to the level of the pre-enactment reserve should result in an adjustment under the new rules.

The following example is illustrative.

Assume that a calendar year taxpayer has a LIFO reserve of $100 at the end of 1984. Assume further that the reserve decreases

[29] Section 54 of the Act and section 311 of the Code.

to $95 at the end of 1985 and increases to $105 at the end of 1986. Finally, assume that the reserve decreases to $90 at the end of 1987.

The change in the reserve for 1985 results in an increase in taxable income and earnings and profits under prior law, and no offsetting adjustment should occur under the new rules. Under prior law, the increase in the reserve in 1986 would reduce taxable income and earnings and profits. This reduction is offset by a $10 adjustment to earnings and profits under the new rules. The $15 reduction in the reserve for 1987 increases taxable income and related earnings and profits. This increase is offset, in part, by a $10 reduction in earnings and profits under the new rules.

The adjustment for 1987 is $10 and not $15 because the provision does not require an adjustment to offset the inclusion in earnings and profits of reserve amounts not previously included in earnings and profits. By the end of 1986, $10 (not $15) of the $100 pre-enactment reserve had been taken into account in determining earnings and profits.

The provision is applicable to the effect on earnings and profits of changes in reserve amounts in taxable years beginning after September 30, 1984.

Deferred gain from installment sales

Under the Act, a corporation's earnings and profits for a year in which the corporation sells property on the installment basis are to be computed as if the corporation did not use the installment method to account for the installment sale. This is accomplished by treating all principal payments as received in the year of the sale. For this purpose, principal payments are to be determined after the application of section 1274, section 483, and other time value of money rules under the Code. The provision applies with respect to all installment sales, including sales of inventory.

The provision is applicable to the effect on earnings and profits of sales occurring after September 30, 1984.

Completed contract method of accounting

A corporation that accounts for income and expenses attributable to a long-term contract on the completed contract method of accounting generally recognizes income and expense in the year in which the contract is completed. Under the Act, a corporation that accounts for income and expense on this method is required to compute earnings and profits as if it were accounting for income and expense attributable to long-term contracts on a percentage of completion basis.

This provision is applicable to the effect on earnings and profits of contracts entered into after September 30, 1984.

ACRS deductions for real property

Under section 312(k), as amended, a corporation's earnings and profits are to be reduced for ACRS deductions with respect to 15-year real property, 18-year real property, and low-income housing by the amount of the deduction that would be allowable if the straight-line method of depreciation were used and the property had a 40-year recovery period.

This provision is applicable to the effect on earnings and profits of property placed in service by the corporation in taxable years beginning after September 30, 1984.

Redemptions

In the case of a distribution by a corporation in redemption of its own stock, earnings and profits are to be reduced in proportion to the amount of the corporation's outstanding stock that is redeemed. However, it is not intended that earnings and profits be reduced by more than the amount of the redemption.

For example, assume that X corporation has 1,000 shares of $10 par value stock outstanding and that A and B each acquired 500 of original issue shares at a price of $20 per share. Assume further that X corporation, which has operated a profitable services-oriented business since its inception, holds net assets worth $100,000 consisting of cash ($50,000) and appreciated improved real property ($50,000), and has current and accumulated earnings and profits of $50,000. If X corporation distributes $50,000 in cash to A in redemption of A's shares in X corporation, earnings and profits and capital account would each be reduced by $25,000. After the transaction, X corporation would have $25,000 of earnings and profits.

If a corporation has more than one class of stock outstanding, its earnings and profits generally should be allocated among the different classes in determining the amount by which a redemption of all or a part of one class of stock reduces earnings and profits. However, earnings and profits generally should not be allocated to preferred stock which is not convertible and which does not participate to any significant extent in corporate growth. Therefore, a redemption of such preferred stock should result in a reduction of the capital account only, unless the distribution includes dividend arrearages, which will reduce earnings and profits.

Similarly, priorities legally required as between different classes of stock should be taken into account in allocating earnings and profits between classes. For example, assume that corporation X has 1,000 shares of class A common stock and 1,000 shares of class B common stock. Both classes are $10 par value stock and were issued at the same time at a price of $20. The class A common has a preference as to dividends and liquidating distributions in a 2:1 ratio to the class B common, and only the class B common has voting rights. Assume further that Corporation X holds net assets worth $210,000 and has current and accumulated earnings and profits of $120,000. If X distributes $140,000 in cash in redemption of all of the class A common, earnings and profits should be reduced by $80,000 and capital account by $60,000.

This provision is applicable with respect to the effect on earnings and profits of distributions after the date of enactment (July 18, 1984).

Special rule for foreign corporations

The amendments made by these provisions apply in determining the earnings and profits of foreign corporations as well as domestic corporations.

Application of these provisions to foreign corporations could have an impact on U.S. persons in at least 3 situations. First, under section 951, a U.S. person owning 10 percent or more of the stock of a controlled foreign corporation must include in gross income a pro rata share of the corporation's subpart F income for the shareholder's year in which or with which the corporation's taxable year ends. Subpart F income is limited to the earnings and profits, computed according to U.S. tax concepts, of the controlled foreign corporation. Thus, to the extent that the Act requires that the earnings and profits of a controlled foreign corporation be computed, for example, by capitalizing and amortizing rather than deducting an item, it could result in an increase in a U.S. shareholder's income.

Second, under section 902, a domestic corporation which owns at least 10 percent of the voting stock of a foreign corporation from which it receives dividends is deemed to have paid a proportionate share of any income taxes paid or deemed paid by such corporation to any foreign country or to any possession of the United States on the "accumulated profits" of such foreign corporation from which the dividends were paid. The so-called "deemed paid" credit to which a qualifying U.S. shareholder is entitled equals the foreign taxes paid by the foreign corporation multiplied by the ratio of the dividends to the foreign corporation's accumulated profits. For this purpose, accumulated profits are essentially equivalent to earnings and profits. Because the Act could have the effect of changing the ratio of dividends to accumulated profits, it could change the section 902 deemed paid credit of the corporation's U.S. shareholders.

Third, section 1248 generally treats certain domestic corporations as recognizing dividend income on the sale or exchange, or other disposition, of the stock of certain foreign corporations. That dividend income is measured by certain earnings and profits of the foreign corporation.

Although the provisions apply to foreign corporations, as well as domestic corporations, the application of the amendments pertaining to LIFO inventory adjustments, installment sales, and the use of the completed contract method of accounting is delayed for certain foreign corporations until taxable years beginning after December 31, 1985. This special effective date generally applies only to foreign corporations deriving less than 20 percent of their gross income from sources within the United States. It is anticipated that this delayed effective date will provide both the Treasury and affected foreign corporations and their shareholders opportunity to consider how those provisions should apply to such foreign corporations.

Distributions to 20-percent corporate shareholders

Under the new earnings and profits rules contained in section 61 of the Act, a corporation's earnings and profits could exceed its taxable income if its income is deferred for purposes of determining gross income but not for purposes of computing earnings and profits. If a corporation with earnings and profits in excess of taxable income were to make a distribution to a corporate shareholder, and the distribution were treated as a dividend qualifying for a dividends received deduction, earnings could be distributed to the corporate shareholder without being subject to tax at the corporate level.

For example, assume that P Corporation owns 100 percent of the stock of X Corporation, that P's basis in such stock is $200, that P and X file separate income tax returns, and that X has no current or accumulated earnings and profits. Assume further that X sells an asset for a $1,000 installment note, realizing an $800 gain. Finally, assume that X borrows $500 secured by the installment note and distributes the $500 to P. Under the provision, absent a special rule, X corporation's earnings and profits would be increased by the amount of gain on the installment sale, and P would treat the $500 distribution as a dividend. Thus P would include the $500 in income but would likely qualify for a 100-percent dividends received deduction. If P later sold its X stock for $200 (the value of that stock if it is assumed that X will ultimately have a $300 tax liability, in present value terms, on account of the installment sale), it would not recognize gain or loss on the sale. As a result, P would have realized an overall profit of $500.

As a result, a special rule was added under which, except as regulations may otherwise provide, the taxable income of a corporate shareholder with a 20-percent or greater interest in the distributing corporation, and such shareholder's basis in the stock of the distributing corporation, are determined as if the new rules contained in section 312(n) did not apply to the distributing corporation. Thus, in the above example, $200 of the distribution by X to P would be a return of capital, and $300 would be taxed to P as gain from the sale or exchange of property under section 301(c)(3). P's basis in the X stock would be reduced to zero, and P would recognize a $200 gain on the sale of the stock.

This special rule does not affect the computation of earnings and profits of either the distributing corporation or the corporate shareholder. Thus, for purposes of computing earnings and profits of X and P, $500 of earnings and profits would be treated as having been transferred from X to P. Furthermore, generally the special rule applies only if the corporate shareholder would, but for the special 20-percent corporate shareholder rule, be entitled to a dividends received deduction with respect to the distribution involved.

Under the rule, a 20-percent corporate shareholder is any corporation owning, directly or indirectly, stock possessing at least 20 percent of the total combined voting power of all classes of stock entitled to vote or at least 20 percent of the total value of all classes of stock (excluding certain preferred stock) of the distributing corporation. Attribution rules apply for purposes of determining stock ownership.

This rule applies to distributions made after the date of enactment.

Regulations

Authority is specifically provided for the Secretary to prescribe such regulations as may be appropriate or necessary to carry out the purposes of the provision. It is anticipated that regulations will provide such adjustments as may be necessary to prevent amounts from being duplicated or omitted. For example, deferred gain on an installment sale included in earnings and profits when realized should not be included in earnings and profits a second time when recognized. It is also anticipated that regulations applying the provision to affiliated groups filing consolidated returns will be prescribed.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $109 million in 1985, $283 million in 1986, $270 million in 1987, $289 million in 1988, and $278 million in 1989.

13. Distributions of Obligations Having Original Issue Discount (sec. 61 of the Act and secs. 312 and 1275 of the Code)[30]

Prior Law

A distribution by a corporation constitutes a dividend only if, among other things, it is made out of current or accumulated earnings and profits. A corporation may distribute as a dividend its own debt obligations. Those obligations will have a fair market value that is less than their face amount if the stated interest rate on them is below the prevailing market rate. In such a case, a shareholder would have dividend income in an amount equal to the fair market value of the obligations distributed to him. Under prior law, however, some distributing corporations contended that earnings and profits were reduced by the principal amount of such obligations. The result could have been to eliminate earnings and profits at the cost of a relatively small dividend tax.

Furthermore, taxpayers argued that, under prior law, debt obligations of a distributing corporation distributed by the corporation to shareholders with respect to their stock were not subject to the original issue discount rules. If that was correct, a shareholder on the cash basis could avoid reporting income with respect to the discount until the debt obligation was transferred or paid, and the discount income might have qualified as capital gain. Similarly, an accrual basis obligor might have claimed interest deductions currently on a ratable basis rather than a constant rate basis, thereby accelerating deduction of the discount.

Reasons for Change

The Congress believed that in the case of a dividend distribution, earnings and profits of the distributing corporation should generally not be reduced by an amount in excess of the amount includible as a dividend in gross income by the recipient of such distribution. Further, the Congress was aware that, under prior law, there may have been a mismatching of income and expense, and an erroneous characterization of income, that could be avoided if obligations bearing economic discount that are distributed by a corporation were explicitly made subject to the general original issue discount rules.

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[30] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 60; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1201; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 47; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 188; and H. Rep. No. 98-861 (June 23, 1984), pp. 843 (Conference Report).

Explanation of Provision

In the case of a distribution by a corporation of its own debt securities at a discount, the corporation's earnings and profits are to be reduced by the issue price of the securities at the time of the distribution, determined as if the obligation had been issued for property under section 1274, as added by the Act. Furthermore, any such securities are to be subject to the original issue discount rules. These provisions apply, however, only if the instruments distributed in fact represent indebtedness of the distributing corporation rather than equity. The provisions are not intended to create any inference that purported debt obligations distributed by a corporation should always be treated as debt. Further, no inference is intended as to the proper treatment with respect to discount instruments distributed as dividends under prior law.

Effective Date

The provision applies to distributions declared after March 15, 1984.

Revenue Effect

The revenue effect of this provision is included in the explanation of the earnings and profits provision.

14. Net Operating Loss, Etc., Carryover Rules (sec. 62 of the Act and secs. 382 and 383 of the Code)[31]

Prior Law

The Tax Reform Act of 1976 substantially revised sections 382 and 383, which relate to the carryover of corporate net operating losses and other corporate tax attributes following acquisitions, including reorganizations. The 1976 Act revisions relating to acquisitions other than reorganizations were generally effective with respect to taxable years beginning after June 30, 1984. Those relating to reorganizations were effective with respect to a reorganization pursuant to a plan of reorganization adopted on or after January 1, 1984. The 1976 Act revisions are not explicitly made applicable to "G" reorganizations (relating to reorganizations of corporations in a title 11 or similar case).

Reasons for Change

A number of technical problems regarding the 1976 Act revisions to sections 382 and 383 were brought to the attention of Congress. These problems will require consideration of additional revisions of the rules.

Explanation of Provision

The 1976 Act amendments relating to acquisitions other than reorganizations are generally effective for taxable years beginning after December 31, 1985. Those relating to reorganizations are effective only with respect to a reorganization pursuant to a plan of reorganization adopted on or after January 1, 1986. In addition, the 1976 Act revisions, insofar as they relate to reorganizations, are amended to clarify that, when they become effective, they will apply to "G" reorganizations. This latter amendment is effective as if included in the amendments made by section four of the Bankruptcy Tax Act of 1980.

Effective Date

The provision is effective as of January 1, 1984.

Revenue Effect

This provision is estimated to decrease budget receipts by less than $10 million annually.

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[31] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 808; H. R. Rep. No. 98-432, Pt. 2 (March 5, 1984), p. 1722; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 48; S. Prt. 98-169, Vol. I (April 2, 1984), p. 203; and H. R. Rep. No. 98-861 (June 23, 1984), pp. 843-844 (Conference Report).

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15. Distribution Requirement in the Case of a "C" Reorganization (sec. 63 the Act and sec. 368 of the Code)[32]

Prior Law

A "C" reorganization is an acquisition by 1 corporation (the acquiring corporation) of substantially all of the properties of another corporation (the transferor corporation) in exchange solely for voting stock of the acquiring corporation or its parent corporation, or in exchange for such voting stock and a limited amount of money or other property. In determining whether an exchange is solely for voting stock, the assumption by the acquiring corporation of a liability of the transferor corporation, or the fact that the property acquired is subject to a liability, generally is disregarded.

The acquiring corporation in a C reorganization succeeds to, and takes into account, the tax attributes of the transferor corporation described in section 381, subject to limitations contained in that section and section 382. For example, the acquiring corporation generally succeeds to the earnings and profits are of the transferor corporation.

Under prior law, a transaction could qualify as a C reorganization even if the transferor corporation did not distribute to its shareholders the consideration received from the acquiring corporation and its other assets, if any. If there was a distribution pursuant to the plan of reorganization by the transferor corporation to its shareholders in exchange for stock in the transferor corporation, section 354 (or so much of section 356 as relates to section 354) applied. Under section 354, no gain or loss was recognized to the shareholders of the transferor corporation on the receipt of stock of the acquiring corporation or its parent. Gain was recognized under section 356, however, on the receipt of other property, but not in an amount in excess of the sum of any money and the fair market value of any other property received. If the receipt of such property had the effect of a distribution of a dividend to a shareholder, the shareholder was treated as receiving dividend income in an amount equal to the amount of the gain realized on the exchange but not in excess of the shareholder's ratable share of earnings and profits of the corporation. The principles of section 302 and section 318 were applicable in testing for dividend equivalency under section 356. Any gain recognized which was not treated as dividend income was treated as gain from the sale or exchange of property.

For purposes of determining the extent to which a shareholder is to be treated as having received a dividend, the relevant earnings and profits are the earnings and profits of the transferor corporation.

[32] For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 49; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 204; and H. Rep. No. 98-861 (June 23, 1984), pp. 844 (Conference Report).

For this purpose, the exchange is generally deemed to occur prior to the time the transferor corporation's earnings and profits were inherited by the acquiring corporation under section 381. Furthermore, the earnings and profits of the transferor corporation inherited by the acquiring corporation under section 381 are generally reduced by amounts treated as a dividend under section 356.

As noted above, under prior law, a transaction could qualify as a C reorganization even if the transferor corporation did not distribute to its shareholders the consideration received from the acquiring corporation and its other assets, if any. Furthermore, the Service ruled that a transaction qualified as a C reorganization where the transferor corporation distributed a 25-percent stock interest in the acquiring corporation but retained liquid assets which it intended to use to engage in an active trade or business. (Rev. Rul. 73-552, 1973-2 C.B. 116.)

Reasons for Change

Prior to 1934, Federal income tax statutes provided for reorganization treatment only in the case of a transaction qualifying as a merger or consolidation under state law. The C reorganization provisions were added to the Code because uniform merger or consolidation statutes had not been enacted in all states, and the Congress believed that for Federal tax purposes substantially similar transactions should be treated consistently without regard to state law. Thus, the C reorganization provisions were generally intended to apply to transactions that were acquisitive in nature and resembled statutory mergers or consolidations.

Different provisions were intended to apply to divisive transactions. Congress was concerned that since a distribution by the transferor corporation of all its assets was not required in connection with a C reorganization, and after such a reorganization the transferor was, in some circumstances, able to engage in an active trade or business and not merely serve as a holding company for its shareholders' interests in the acquiring corporation, transactions that were somewhat divisive in nature might have qualified as reorganizations without qualifying under the provisions generally applicable to divisive transactions.

In addition, as stated above, the C reorganization provisions were intended to apply to transactions that resemble, in substance, statutory mergers or consolidations. In the case of a statutory merger or consolidation, the transferor is "liquidated" by operation of law. The Congress believed that since the transferor by definition distributes all its assets in a statutory merger and consolidation, it should be required to distribute all its assets in a C reorganization.

Also, under prior law, there was an incongruity between the provisions of the Code that provided for the carryover of an acquired corporation's tax attributes and the C reorganization provisions, which did not require the distribution of all the transferor corporation's assets. As a result, a transferor corporation could remain in existence and hold assets having substantial value (e.g., the stock of the acquiring corporation and other assets) and be treated for Federal tax purposes as a new corporation without tax attributes. The Congress was concerned that opportunities for tax avoidance might result if a corporation that had been in existence could engage on a tax-free basis in a transaction that, in effect, erased its tax history and yet not distribute all its assets. For example, under prior law, it may have been possible to avoid the rules requiring that amounts distributed to shareholders out of current or accumulated earnings and profits be treated by the shareholders as dividends taxable at ordinary income rates.[33]

Explanation of Provision

Under the provision, a transaction can qualify as a C reorganization only if the transferor corporation distributes the stock, securities, and other properties it receives, as well as its other properties, in pursuance of the plan of reorganization. The Act does not require that the distribution be completed within a specified time period. However, the Congress anticipated that the distribution will take place reasonably promptly and that the transferor corporation will not engage in the active conduct of a trade or business after the reorganization except to the extent necessary to wind up its affairs.

The Congress did not intend to preclude C reorganization treatment to a transferor corporation merely because it does not distribute the property received from the acquiring corporation, and the other property held by it immediately after the reorganization, so long as it distributes either such property or any property received on the sale or exchange of such property during the distribution period, and so long as any such sale or exchange is in pursuance of the plan of reorganization. There is no inference, however, that any such sale or exchange would itself be tax-free.

The Congress intended that distributions of property to creditors of the transferor, as well as shareholders, qualify as distributions for purposes of the provision of the Act, so long as those distributions are in pursuance of the plan of reorganization.

Under the Act, the Secretary may waive the application of the distribution requirement, subject to any conditions that the Secretary may prescribe. It is anticipated that waivers will be granted only (1) if a distribution would result in substantial hardship, and (2) only on the condition that the transferor corporation and its shareholders be treated as if the undistributed assets had been distributed and then contributed to the capital of a new corporation. Such a constructive distribution might give rise to dividend income to shareholders.

The Secretary is also granted authority to issue regulations providing for the allocation of earnings and profits in a C reorganization or a D reorganization. These regulations could provide for allocation of the earnings and profits of the transferor corporation between or among such corporation, any corporation in control of the transferor corporation immediately before the reorganization, and the acquiring corporation. It is anticipated that under those regula-

[33] If a transferor corporation that prior to the reorganization had substantial earnings and profits remained in existence, and the corporation made distributions to its shareholders out of the retained assets or cash received from the acquiring corporation or from lenders, the distributions might have been treated by the shareholders as a return of capital. If, in contrast, the distributions were made prior to the reorganization, they would have been treated as dividends.

tions, generally the consequences of an A reorganization (e.g., a merger) preceded by a distribution, on the one hand, and a C (or non-divisive D) reorganization followed by a distribution, on the other hand, generally will be consistent. In this regard, it is also anticipated that the Treasury might reconsider its regulations relating to allocations of earnings and profits in transactions under section 355.

Effective Date

The provision applies to transactions pursuant to plans adopted after the date of enactment by any corporation which would be a party to the reorganization if the transaction qualified as a reorganization.

Revenue Effect

The provision is estimated to increase budget receipts by less than $10 million annually.

16. Control Requirement in a "D" Reorganization (sec. 64 of the Act and sec. 368 of the Code)[34]

Prior Law

"D" reorganizations

Under section 368(a)(1)(D), a transfer by a corporation of all or a part of its assets to a corporation controlled immediately after the transfer by the transferor or one or more of its shareholders is generally treated as a "D" reorganization if, among other things, stock or securities of the controlled corporation, as well as its other properties, are distributed in a transaction qualifying under sections 354, 355, or 356. For the transaction to qualify under section 354 (or so much of section 356 as relates to section 354), the acquiring corporation must acquire substantially all the assets of the transferor corporation (a non-divisive D reorganization).

Under prior law, for purposes of determining whether a transaction qualified as a D reorganization, the term "control" was defined as the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation. No attribution rules were explicitly made applicable.

Liquidation and contribution to a related corporation

In general, under section 331, amounts distributed to a shareholder in complete liquidation of a corporation are treated as in full payment in exchange for the shareholder's stock. If the stock is a capital asset in the hands of the shareholder, a complete liquidation will result in capital gain or loss. The shareholder's basis in the property received in such a liquidation is the fair market value of the property at the time of the distribution. With several exceptions, no gain or loss is recognized to the distributing corporation on a distribution in complete liquidation of such corporation or a liquidating sale by the corporation.

Under section 351, generally no gain or loss is recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and, immediately after the exchange, such person or persons are in control of the corporation. As a general rule, a transferor takes a substituted basis in stock or securities of the transferee received in the exchange. The transferee's basis in property received from the transferor is generally determined by reference to the basis of such property in the transferor's hands.

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[34] For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 50; S. Prt. 98-169, Vol. I (April 2, 1984), p. 207; and H. Rep. No. 98-861 (June 23, 1984), p. 846 (Conference Report).

Sale of stock to commonly controlled corporation

A sale of stock in 1 corporation by a shareholder to a commonly controlled corporation is generally treated under section 304 as a redemption rather than as a sale. A distribution in redemption of stock is generally treated by the shareholders as in part or full payment in exchange for the stock if (1) it is not essentially equivalent to a dividend, (2) it is substantially disproportionate with respect to the shareholder, (3) it is in complete termination of the shareholder's interest, or (4) certain other requirements are satisfied. Distributions in redemption of a shareholder's stock that are not treated as in part or full payment in exchange for the stock are treated as dividends to the extent of earnings of profits.

For purposes of section 304, the term control means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote, or at least 50 percent of the total value of shares of all classes of stock. Attribution rules apply for purposes of determining ownership of stock.

Reasons for Change

The Congress was aware that under prior law, liquidation-reincorporation transactions (i.e., transactions involving the liquidation of a corporation coupled with a transfer of its operating assets to a new corporation in which the shareholders of the transferor corporation have a substantial stock interest) that were not treated as reorganizations could be used to accomplish a bail-out of earnings and profits at capital gains rates. Further, these transactions could be used by a shareholder (or group of shareholders) to obtain a step-up in the basis of assets that were held in corporate solution largely at the cost of a shareholder-level capital gains tax without a significant change in ownership of those assets.

The D reorganization provisions generally envision the continuation of the transferor corporation's business in a corporation in which the transferor corporation or its shareholders have a substantial interest. In many liquidation-reincorporation transactions, the liquidating corporation's business is being continued by a related corporation. The Congress believed that many of these transactions should be treated as D reorganizations. However, in some instances, the control requirement that applied in the case of a D reorganization prevented the Service from successfully asserting that these transactions constituted D reorganizations.

Also, the D reorganization provisions and section 304 both operate to prevent the bail-out of earnings and profits at capital gains rates. The D reorganization provisions address the bail-out problem in the context of a transfer of assets by 1 corporation to another. Section 304 deals with the problem in the context of a transfer of stock by shareholders to a corporation they control. Nonetheless, the definition of control that applied for purposes of the D reorganization provisions differed from the definition that applies for purposes of section 304. Further, attribution rules applied for purposes of determining stock ownership under section 304, but not for purposes of determining stock ownership under the D reorganization provisions.

The Congress believed that the D reorganization control requirement should more closely conform to the control requirement under section 304. In addition, the Congress believed that the absence of explicit attribution rules to determine ownership of stock for purposes of the D reorganization control requirement may have enabled taxpayers to bail out earnings and profits at capital gains rates by having their corporation transfer assets to a corporation controlled by related persons rather than to a corporation controlled by them. Generally, because attribution rules are applicable for purposes of section 304, such a bail out would not be possible if the transaction were structured as a transfer of stock rather than of assets.

Explanation of Provision

Under the provision, for purposes of determining whether a nondivisive transaction qualifies as a D reorganization, "control" is defined as ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote, or at least 50 percent of the total value of all shares of all classes of stock. Further, the constructive ownership of stock rules contained in section 318(a), as modified, are applicable for purposes of determining whether the transferor corporation or its shareholders are in control of the acquiring corporation.

It was not intended that recharacterization as a D reorganization under this provision be the exclusive means for the Service to challenge liquidation-reincorporation and similar transactions. Thus, it was not intended that this provision supersede or otherwise replace the various doctrines that have been developed by the Service and the courts to deal with such transactions. See, e.g., Rev. Rul. 61-156, 1961-2 C.B. 62; *Telephone Answering Service Co.* v. *Commissioner*, 62 T.C. 423 (1974), *aff'd.*, 546 F.2d 423 (4th Cir. 1976), *cert. denied,* 431 U.S. 914 (1977); and *J.E. Smothers* v. *U.S.*, 642 F.2d 894 (5th Cir. 1981).

Effective Date

This provision is applicable to transactions pursuant to plans of reorganization adopted after the date of enactment (July 18, 1984) by any corporation which would be a party to the reorganization if the transaction qualified as a reorganization.

Revenue Effect

The provision is estimated to increase budget receipts by less than $10 million per year.

17. Collapsible Corporations (sec. 65 of the Act and sec. 341 of the Code)[35]

Prior Law

The collapsible corporation rules are designed to prevent the use of a corporation to convert what would be ordinary income in the hands of a shareholder to capital gain. A shareholder's gain on the sale or exchange of stock in a collapsible corporation is generally required to be reported as ordinary income.

The collapsible corporation rules are inapplicable if the collapsible corporation realizes a "substantial part" of the income to be derived from its collapsible assets. In *Commissioner* v. *Kelley*, 293 F.2d 904 (5th Cir. 1961), the court held that the "substantial part" test is satisfied if the corporation has realized one-third of the income to be derived from its collapsible assets. *Contra Abbot v. Commissioner*, 258 F.2d 537 (3d Cir. 1958).

Under a second exception, the collapsible corporation rules were inapplicable if 70 percent or less of a shareholder's gain on the disposition of his stock in the corporation was attributable to collapsible assets (the "70/30" rule).

Reasons for Change

Congress was concerned about the opportunities for avoidance of the collapsible-corporation rules provided by the holding of the *Kelley* case and the existing regulations interpreting the 70/30 rule. Congress determined that property that is collapsible should continue to be so treated unless only an insubstantial portion of the taxable income to be realized from the property remains unrealized.

With respect to the 70/30 rule, Congress was also concerned about the possibilities for avoiding collapsible treatment where a collapsible corporation had two or more separate projects. For example, assume that a corporation builds or acquires two similar but separate inventory-type assets or projects, with a view toward collapsing the corporation prior to the time it has realized a substantial part of the taxable income to be derived from either asset. Each asset is of equal value at all relevant times. The corporation is owned entirely by one shareholder. The corporation is liquidated. Under prior law, if the selling shareholder caused the corporation to realize one-third of one of its assets prior to the date of the liquidation, that asset would be treated as non-collapsible for purposes

[35] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 164; H.R. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1382-1384; Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 51; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 210-212; and H.R. Prt. No. 98-861 (June 23, 1984), p. 848 (Conference Report).

of the 70/30 rule. Since less than 70 percent of the recognized gain on the stock sale would be attributable to a collapsible asset, the 70/30 rule would apply to except the sale proceeds from the collapsible corporation rules, even though only one-sixth of the total potential income from the assets had been recognized.

Explanation of Provision

The Act provides that the "substantial part" test requires the realization of at least two-thirds of the income from collapsible assets. In addition, the Secretary is authorized to promulgate regulations to make conforming changes to the 70/30 rule, treating all property described in section 1221(1) as one item of property.

In general, property described in section 1221(1) consists of inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of a trade or business. If the aggregate of the corporation's collapsible section 1221(1) properties is less than two-thirds realized, all of the corporation's collapsible section 1221(1) properties will be treated as collapsible property for purposes of the 70/30 rule. For purposes of applying this aggregation requirement under the "70/30" rule, all property with respect to which the taxpayer has, or at any time had, a view to collapse will be treated as collapsible property (i.e., property described in section 341(b)(1)). Section 1221(1) property that is not and never was collapsible property need not be aggregated under this rule.

Effective Date

The provision is effective for sales, exchanges, and distributions made after the date of enactment (July 18, 1984).

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $5 million in 1984, $57 million in 1985, $196 million in 1986, $305 million in 1987, $351 million in 1988, and $382 million in 1989.

18. Phaseout of Graduated Rates for Large Corporations (sec. 66 of the Act and sec. 11 of the Code)[36]

Prior Law

Corporate taxable income was subject to tax under a five-step graduated tax rate structure. The top corporate tax rate was 46 percent on taxable income over $100,000.

The corporate taxable income brackets and tax rates are presented in the following table:

Taxable income:	*Tax rate*
0-$25,000	15
$25,000-$50,000	18
$50,000-$75,000	30
$75,000-$100,000	40
Over $100,000	46

For corporations whose income was $100,000 or more, the corporate tax was $20,250 less than would have been the case under a 46-percent flat rate.

Reasons for Change

The graduated corporate tax rates were added in 1978 to ease the tax burden on small business. However, large corporations, as well as small corporations, are entitled to these benefits. Congress believes that large corporations should not be able to take advantage of this small business provision. Therefore, the benefits of the graduated tax rates are generally eliminated for any corporation with large income.

Explanation of Provision

An additional 5-percent corporate tax is imposed on a corporation's taxable income in excess of $1 million. However, the maximum additional tax is $20,250. Thus, the benefit of the graduated rates is eliminated for corporations with income in excess of $1,405,000.

For purposes of applying these rules, the component members of a controlled group of corporations are treated as one corporation (sec. 1561).

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[36] For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 44; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 190-191; and H. Rep. No. 98-861 (June 23, 1984), pp. 848-849 (Conference Report).

Effective Date

The provision applies to taxable years beginning after December 31, 1983.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $70 million in 1984, $212 million in 1985, $185 million in 1986, $190 million in 1987, $192 million in 1988, and $194 million in 1989.

19. Golden Parachute Contracts (sec. 67 of the Act and secs. 280G and 4999 of the Code)[37]

Prior Law

Prior law generally permitted a taxpayer a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. Generally, reasonable compensation for salaries or other compensation for personal services actually rendered qualifies as ordinary and necessary trade or business expenses, as did other items. Compensation paid to an individual generally is treated as ordinary income, taxable at a rate of up to 50 percent.

Reasons for Change

In recent years, there has been a large volume of activity involving acquisitions and attempted acquisitions of corporations by other taxpayers. In many instances, the "target" corporation has resisted being taken over. In other cases, acquisitions have gone forward on a "friendly" basis. In both situations, however, arrangements were often made to provide substantial payments to top executives and other key personnel of the target corporation in connection with any acquisition that might occur.

In many "hostile" takeover situations, the Congress believed that such arrangements, commonly called "golden parachutes," were designed in part to dissuade an interested buyer, by increasing the cost of the acquisition, from attempting to proceed with the acquisition. If the takeover did not occur, the target's executives and other key personnel would more likely retain their positions, so the golden parachute could have had an effect of helping to preserve the jobs of such personnel. Where no takeover had yet commenced but the corporation viewed itself as an unwilling potential target, the Congress believed that golden parachutes were oftentimes entered into to discourage potential buyers from becoming interested. It was the view of Congress that to the extent golden parachutes had the desired effect in either such a case, they hindered acquisition activity in the marketplace and, as a matter of policy, should be strongly discouraged.

In other situations, the Congress was concerned that the existence of such arrangements tended to encourage the executives and other key personnel involved to favor a proposed takeover that might not be in the best interests of the shareholders or others. This could happen if such personnel knew they would be handsomely rewarded if an acquisition took place. It could happen

[37] For legislative background of the provisions, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 46; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 195-196; H. Rep. No. 98-861 (June 23, 1984), pp. 849-854 (Conference Report).

whether the arrangements were between such personnel and the target corporation, between such personnel and the acquiring company, or between such personnel and any other person interested in the takeover. To the extent such arrangements might have had that effect, Congress determined that they similarly should be strongly discouraged.

In almost any takeover situation, be it hostile or friendly, the acquiring company in theory will pay a maximum amount and no more. To the extent some of that amount, directly or indirectly, must be paid to executives and other key personnel of the target corporation, because of the existence of golden parachutes or similar arrangements, there is less for the shareholders of that corporation. Congress decided to discourage transactions which tended to reduce amounts which might otherwise be paid to target corporation shareholders.

Explanation of Provisions

General rules

Under the Act, no deduction is allowed for "excess parachute payments." Furthermore, if any such payment is made by the acquiring company, or a shareholder of the acquired or the acquiring company, Congress did not intend that it be treated as part of the acquiring company's purchase price for the acquired company, or as increasing the shareholder's basis in his stock in the acquired or acquiring company.

Finally, a nondeductible 20-percent excise tax is imposed on the recipient of any excess parachute payment.

Parachute payment

A "parachute payment" is any payment (1) in the nature of compensation (including payments to be made under a covenant not to compete or similar arrangement), (2) to (or for the benefit of) a "disqualified individual", (3) if such payment is contingent on a change in the ownership or effective control of a corporation, or in the ownership of a substantial portion of its assets—but only if the aggregate present value of all such payments made or to be made to the disqualified individual equals or exceeds 3 times the disqualified individual's "base amount."

The disqualified individual's "base amount" is the average annual income in the nature of compensation (including, for example, ordinary income with respect to stock options) with respect to the acquired corporation includible in the disqualified individual's gross income over the 5 taxable years of such individual preceding the individual's taxable year in which the change in ownership or control occurs. (If the individual did not perform services for the corporation throughout that 5-taxable-year period, the relevant period is that portion of the 5-taxable-year period in which he did perform services for the corporation, with compensation for any portion of a taxable year being annualized before an average is determined. Thus, if an individual was employed by the corporation for 2 years and 4 months preceding his taxable year in which the change in ownership or control occurs and his compensation income from the corporation was $30,000 for the 4-month period,

$120,000 for the first of such 2 full years, and $150,000 for the second, his base amount would be $120,000 (the sum of ($30,000 x 3) + $120,000 + $150,000, divided by 3).) The Secretary is to prescribe regulations determining the base amount in any case in which the disqualified individual did not perform services for the corporation prior to his taxable year in which the change in ownership or control occurs.

A "disqualified individual" means any individual who is an employee, independent contractor, or other person specified in regulations who performs personal services for the corporation and who is an officer, shareholder, or highly-compensated individual of such corporation. (It is contemplated that regulations will provide an exception for shareholders of the acquired corporation holding *de minimis* amounts of its stock who are not officers or highly-compensated individuals of the corporation.) Personal service corporations and similar entities generally are treated as individuals for this purpose. Thus, for example, if an officer of a corporation performs services for that corporation through a personal service corporation, parachute payments to the personal service corporation are to be treated as made to a disqualified individual.

To be a parachute payment, a payment must be contingent on a change in ownership or control. In general, a payment is to be treated as contingent on a change in ownership or control if such payment would not in fact have been made had no change in ownership or control occurred. A payment generally is to be treated as one which would not have in fact been made unless it is substantially certain, at the time of the change, that the payment would have been made whether or not the change occurred. A payment may be a parachute payment even if the target corporation neither paid it nor had any obligation to pay it but it is paid by the acquiring company (for example, under an employment contract, consulting agreement, covenant not to compete, or similar arrangement) or any other person interested in the change. A payment may also be a parachute payment if it is contingent on an event closely associated with a change in ownership or control (for example, the onset of a tender offer). Furthermore, a payment is also to be treated as contingent on a change in ownership or control if the change determines the time such payment is in fact to be made. Finally, a payment may be a parachute payment even if the employment or similar relationship of the disqualified individual is not terminated (voluntarily or involuntarily) as a result of the change in ownership or control.

The following examples illustrate the "contingent on a change in ownership or control" concept.

Example (1).—Assume that a contract provides that payments are to be made to a disqualified individual if a change in control of the corporate employer occurs. Assume that, more than 1 year after the contract is entered into, control does change and that payments are made under the contract. The payments are contingent on a change in ownership or control, even if the individual continues in the employ of the target corporation (or the acquiring company).

Example (2).—Assume that a contract is entered into providing for payments to a disqualified individual contingent upon his employment being terminated at any time over the succeeding 3 years. Eighteen months later, a change of control occurs, and shortly thereafter, the individual's employment terminates. Under this example, a factual determination must be made as to why employment was terminated. If termination occurred because of the change, payments under the contract are to be treated as contingent on the change in control.

Example (3).—Assume that a disqualified individual is a common law employee of a corporation. A change in control of the corporation occurs, and, pursuant to a formal or informal understanding reached before the change occurs, the individual enters into an employment agreement, consulting agreement, agreement not to compete, or similar arrangement with the acquiring company for a term of 3 years. An amount equal to the value, generally determined as of the date the contract becomes operative, of payments to be made under such an agreement is to be treated as contingent on the change in control.

Example (4).—Assume that a contract between a disqualified individual and the corporate employer provides for the acceleration of vesting or payment of deferred incentive compensation, for the acceleration of the time for the exercise of stock options, or for payments in cancellation of stock options, contingent on a change in control of the corporation, and that a change in ownership or control occurs. Payments resulting from such a contract are to be treated as contingent on the change in control.

Parachute payment presumption

Under the Act, payments under a contract entered into within 1 year before a change in ownership or control are to be presumed contingent on such a change unless the contrary is established by clear and convincing evidence. Whether the presumption can be rebutted will depend on the circumstances surrounding the execution of the contract, including what the contract provides and whether it was entered into at a time when a takeover attempt had commenced or the corporation otherwise viewed itself as a likely takeover candidate. For example, suppose a corporation and a disqualified individual who was a common-law employee enter into a contract calling for a lump-sum severance payment to the individual upon termination, for whatever reason (including death, retirement, or termination for cause), of his employment. The contract was entered into after the corporation had been advised by its investment banker that it was a prime takeover candidate. Nine months later, the corporation is taken over. Subsequently, the individual's employment is terminated. Payments under the contract are treated as contingent on a change in control even though the payments would legally have been required even had no change occurred, unless the 1-year presumption is rebutted by clear and convincing evidence,

If a contract which does not provide for any payments contingent on a change in ownership or control and which is entered into more than 1 year before the change is amended less than 1 year before the change, the presumption is to be applied only to payments pursuant to the amendment.

Property transfers

Under the Act, transfers of property are to be treated as payments for purposes of applying the provisions. Any such property generally is taken into account in an amount equal to its value at the date of transfer, and all such property is to be valued. For this purpose, the terms "transfer" and "property" are to be interpreted broadly. Thus, for example, the grant of stock options to a disqualified individual with respect to an acquired corporation by an acquiring corporation as a part of the acquisition transaction are transfers of property.

Change in ownership or control

Whether a particular transaction involves a change in the ownership or effective control of a corporation or in the ownership of a substantial portion of its assets is to be determined under all the facts and circumstances, giving due regard to the purposes of the provisions.

Excess parachute payments

"Excess parachute payments" are any parachute payments in excess of the base amount which are not reasonable compensation for personal services actually rendered (or to be rendered) by the disqualified individual. Under the Act, it is presumed that no parachute payment is reasonable compensation for personal services. Such presumption is rebuttable by clear and convincing evidence.

To the extent the taxpayer establishes that the payment involved is reasonable compensation for personal services, the amount involved is first applied against the base amount. However, the Congress intended that personal services adequately compensated for by payments that are not parachute payments not be taken into account in determining whether parachute payments are payments of reasonable compensation.

To illustrate these rules, assume that the disqualified individual's base amount is $100,000. Assume further that a payment totalling $400,000, which is contingent on a change in control, is made to the disqualified individual on the date of the change. Under the Act, parachute payments total $400,000, and the provisions apply because $400,000 exceeds $300,000 (3 times the base amount). Excess parachute payments are as much as $300,000 ($400,000 less $100,000, the base amount). Assume that the taxpayer by clear and convincing evidence establishes that reasonable compensation for services compensated for by the parachute payment totals $150,000. Under the Act, excess parachute payments equal $250,000 ($300,000 less ($150,000 less $100,000)).

If, in the above example, payments contingent on the change in ownership or control totalled $290,000, the provisions of the Act would not apply. In that case, those payments would not equal or exceed $300,000 (3 times the base amount). This result would follow even if the taxpayer was unable to establish that any of the $290,000 was reasonable compensation for personal services actually rendered. The tax consequences of the payment of the $290,000 would be determined under prior law.

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Reasonable compensation

The Congress believed that in most large, publicly-held corporations, top executives are not under-compensated. Accordingly, the Congress contemplated that only in rare cases, if any, will any portion of a parachute payment be treated as reasonable compensation in response to an argument that a disqualified individual with respect to such a corporation was under-compensated for periods prior to the change in ownership or control.

On the other hand, payments of compensation previously earned are generally to be treated as reasonable compensation under the provisions, assuming they qualify as reasonable compensation under section 162. For example, payments under the following agreements would generally be treated as reasonable compensation under the provisions if such payments would have been made in the future in any event, even though the timing of such payments is in fact triggered by a change in ownership or control: (1) payments in cancellation of a normal stock option, or normal stock appreciation right, granted more than 1 year before the change; (2) the right to exercise, after termination of employment, stock options or stock appreciation rights issued as part of a normal compensation package granted more than 1 year before the change; (3) compensation deferred pursuant to a plan of the employer, such as a staggered bonus plan, or at the election of the executive; and (4) payments under a retirement plan that supplements a tax-qualified plan to the extent designed to compensate a newly-hired highly-compensated individual for the loss of retirement benefits attributable to services actually performed for a prior employer.

As indicated above, an amount equal to the value of payments to be made under an employment contract, consulting agreement, covenant not to compete, or similar arrangement for a stated term entered into between the acquiring company and a disqualified individual with respect to the target corporation may constitute parachute payments. To the extent payments under such an agreement are, at the time such agreement is entered into, determined to be reasonable for the consideration (including consideration in the form of not competing) to be provided by the individual under the agreement, such payments are to be treated under the provisions as reasonable compensation for personal services actually rendered. In the case of an employment contract, whether payments under it would be deemed reasonable would depend on all the facts and circumstances, including the individual's historic compensation, the duties to be performed under the contract, and the compensation of individuals of comparable skills outside of an acquisition context.

Violation of securities laws or regulations

Under the Act, the term parachute payment also includes any payment under a contract that (1) provides for payments of a type which the Congress intended to discourage by enacting the new rules, and (2) that violates any applicable securities laws or regulations. However, the rules relating to reasonable compensation are not applicable in determining how much of any such parachute payment is excessive.

For this purpose, the Congress intended that applicable securities laws or regulations include State as well as Federal laws or regulations. However, the Congress intended this rule to apply only if the violation is a serious one. It was not intended to apply if the violation is merely technical in character or is not materially prejudicial to shareholders or potential shareholders.

Excise tax

As is indicated above, a nondeductible 20-percent excise tax is imposed on the recipient of any excess parachute payment. In general, the Congress intended that, except as regulations may provide to the contrary, this tax be imposed for the taxable year of the recipient in which the payment is properly includible in the recipient's gross income under general Code principles, without regard to special rules deferring the taxable year of inclusion.

Withholding

The Act provides that an amount equal to the excise tax is to be withheld under section 3402 upon payment of excess parachute payments constituting wages. The Act also provides rules as to when excess parachute payments are taken into account under the FICA tax provisions.

Application

In determining whether payments contingent on a change in ownership or control equal or exceed 3 times the base amount, the value of amounts to be paid on a future date certain is to be determined on a present value basis in accordance with the principles of section 1274(b)(2), as added by the Act. Under that section, a discount rate equal to 120 percent of the applicable Federal rate, compounded semiannually, is to be used. Except as regulations may provide to the contrary, present values are to be determined as of the date the contract under which the payments are to be made becomes operative.

Where the amount of the payments contingent on a change in ownership or control depends on some uncertain future event, the likelihood that that event will occur is to be taken into account in determining value. For example, assume that a disqualified individual is entitled to payments contingent on a change having a present value equal to 4 times the base amount, less any compensation the disqualified individual earns from unrelated employers in the succeeding 3 years. If, under all the facts and circumstances, it can be determined, at the time the contract becomes operative, that the present value of such compensation is twice the base amount, then the payments are not parachute payments. If, on the other hand, it cannot be determined, at that time, that the individual will earn any such compensation, the payments are parachute payments.

The provisions are to be applied to that part of each parachute payment which is in excess of the portion of the base amount allocated to such payment. Under the Act, the portion of the base amount allocated to any payment is that portion of the base amount determined by multiplying the base amount by a fraction the numerator of which is the present value of such payment, and the denominator of which is the aggregate present value of all such payments. Any reasonable compensation in excess of the base amount is to be allocated to the first parachute payments made.

Other rules

The Act contains broad regulatory authority, authorizing the Treasury to prescribe such regulations as may be necessary to carry out the purposes of the provisions. These are to include, without limitation, regulations applying the provisions in the case of related corporations and personal service corporations and similar entities. They are also to detail the effect of the rules regarding the disallowance of a deduction (1) where a deduction was taken in a year prior to the change, as under section 404, (2) where incentive stock options are involved, and (3) in other cases.

No inference was intended as to the deductibility under prior law of amounts paid or incurred under so-called golden parachute agreements. Nor was any inference intended as to the deductibility of any payments contingent on a change in ownership or control which do not have a present value in excess of 3 times the applicable base amount.

Effective Date

The provisions are effective for payments made under contracts entered into or renewed after June 14, 1984. For this purpose, the grant, after June 14, 1984, of a stock option or similar arrangement under a plan approved prior to that date is not to be treated as a pre-June 14, 1984, contract. A contract cancellable unconditionally at will by either party to it, the disqualified individual or the company, is to be treated as a new contract entered into on the date any such cancellation, if made, would be effective. Thus, for example, if an employer can, at will, cancel a golden parachute contract entered into before June 15, 1984, by giving 3-months notice, the contract is to be treated as a new contract on September 15, 1984, whether or not it is in fact cancelled. The Congress did not intend that a parachute contract be treated as cancellable at will for this purpose if it could be cancelled only by terminating the employment relationship or similar relationship of the individual involved as well. In such a case, cancellation would produce a significant change in the relationship of the parties to each other in addition to merely terminating a parachute arrangement.

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. Under this rule, the provisions will apply to payments made under pre-June 15, 1984, contracts which are amended or supplemented in significant relevant respect after June 14, 1984, even though, had no such amendment or supplement occurred, payments under the pre-June 15, 1984, contract would have been grandfathered.

A contract is to be treated as amended or supplemented in significant relevant respect only if those provisions of it in the nature of parachute provisions are amended or supplemented in a manner that provides significant additional benefits to the executive. Thus, for example, a contract generally is to be 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, where payment is to be made under a formula, to modify, to the executive's advantage, the formula) 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. However, a stock option which is currently exercisable whether or not a change in ownership or control occurs is not to be treated as amended in significant material respect merely by reason of an amendment permitting the disqualified individual to surrender it for cash or other property. Since the disqualified individual could have exercised the option and then sold the stock received upon the exercise, the individual is not materially benefitted by the amendment.

Nor is a contract to be treated as amended or supplemented in significant relevant respect merely by reason of normal adjustments in the terms of the employment relationship or similar relationship. For example, if a pre-June 15, 1984, contract calls for a payment in the event of a change in ownership or control equal to 4 times a disqualified individual's annual compensation, a normal increase in his annual compensation is not to be treated as an amendment or supplement to the contract. Similarly, if a corporation, consistent with its historical practices, after June 14, 1984, grants non-vested stock options to a large group of disqualified individuals or other employees, only 1 or a few of whom have grandfathered contracts, and the vesting of all such options is accelerated in the event of a change in ownership or control, the grant generally is not to be treated as a significant amendment or supplement to those contracts (although the provisions are applicable to the options). Whether any adjustment in the terms of the relationship will be considered normal for this purpose depends on all the facts and circumstances. These would include (1) the length of time between the adjustment and the change in ownership or control, (2) the extent to which the corporation, at the time of the adjustment, viewed itself as a likely takeover candidate, (3) a comparison of the adjustment with historical practices of the corporation, (4) the extent of overlap between the group receiving the benefits of the adjustment and those members of that group who are the beneficiaries of pre-June 15, 1984, parachute contracts, and (5) the size of the adjustment, both in absolute terms and in comparison with the benefits provided to other members of the group.

Revenue Effect

The provisions are estimated to increase fiscal year budget receipts by less than $5 million per year.

20. Corporate Tax Preferences (sec. 68 of the Act and secs. 57 and 291 of the Code)[38]

Prior Law

Under prior law (and present law), corporations pay a minimum tax on certain tax preferences. The tax is in addition to the corporation's regular tax. The amount of the minimum tax is 15 percent of the corporation's tax preferences in excess of the greater of the regular income tax paid or $10,000.

The tax preference items included in the base for the minimum tax for corporations are:

(1) Accelerated depreciated on real property in excess of straight-line depreciation over the useful life or recovery period (in the case of property eligible for ACRS, 15 years);

(2) Amortization of certified pollution control facilities (the excess of 60-month amortization over depreciation otherwise allowable);

(3) In the case of certain financial institutions, the excess of the bad debt deductions over the amount of those deductions computed on the basis of actual experience;

(4) Percentage depletion in excess of the adjusted basis of the property; and

(5) 18/46 of the corporation's net capital gain.

In addition, prior law provided for a 15-percent cutback in certain corporate tax preferences. Adjustments were made to the corporate minimum tax to prevent the combination of that tax and the cutback provision from unduly reducing the tax benefit from a preference.

The cutback applied to the following items as described below:

(1) *Depletion for coal and iron ore.*—The excess of percentage depletion otherwise allowable for iron ore and coal (including lignite) over the adjusted basis of the property was reduced by 15 percent. However, only 71.6 percent[39] of the excess of the allowable deple-

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[38] For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 45; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 192-194; Senate floor amendment, 130 Cong. Rec. S. 4551 (April 12, 1984); and H. Rep. No. 98-861 (June 23, 1984), p. 856 (Conference Report).

[39] The 71.6 percent figure is what is needed to prevent the combination of the add-on minimum tax and the 15-percent preference cutback from reducing the tax benefit from the taxpayer's marginal dollar of preference by more than it is currently cut back by the minimum tax for a taxpayer who has a 46-percent marginal regular tax rate, paid more than $10,000 of regular tax and had tax preferences in excess of regular tax liability. Consider, for example, a taxpayer with $100 of percentage depletion. He received a regular tax benefit of $46 from the preference under prior law. However, the preference led to a direct minimum tax of $15 (the 15-percent minimum tax rate times the $100 preference), as well as an indirect minimum tax of $6.90 through the reduction in the deduction for regular taxes under the minimum tax ($46 times 15 percent). Thus, the net tax benefit from the preference, at the margin, was $24.10.Under the preference cutback, the depletion deduction is reduced to $85, reducing its regular tax benefit to $39.10 (46 percent times $85). Including only 71.6 percent of the preference ($60.86) in the minimum tax reduces the direct minimum tax to $9.13 (15 percent times $60.86). Together with the indirect minimum tax through the reduction in the deduction for regular taxes (15 percent

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tion allowances for these minerals over the adjusted basis of the property was treated as a corporate tax preference under the minimum tax (under section 57(a)(8)).

(2) *Bad debt reserves.*—The bad debt reserve deduction (under sec. 585 or 593) was reduced by 15 percent of the amount by which the otherwise allowable deduction exceeded the amount which would have been allowable on the basis of actual experience. Only 71.6 percent of the excess of the allowable deduction over what would be allowable based on actual experience was treated as an item of tax preference under the minimum tax (under sec. 57(a)(7)).

(3) *Tax exempt interest.*—In the case of a financial institution, 15 percent of the otherwise allowable interest deduction allocable to debt incurred or continued to purchase tax-exempt obligations acquired after 1982 was disallowed.

(4) *DISC.*—The deemed dividend distribution by a domestic international sales corporation (DISC) to a corporate shareholder (under sec. 995(b)(1)(F)(i)) was increased by 15 percent, to 57 1/2 percent of certain taxable income. This change had the effect of reducing the tax benefit from DISC by 15 percent.

(5) *Section 1250 property.*—The amount treated as ordinary income on the sale or other disposition (including certain nonrecognition transactions) of section 1250 property (real estate) by a corporation was increased by 15 percent of the additional amount which would have been treated as ordinary income if the property were subject to recapture under section 1245 (the rule applicable to personal property). The minimum tax preference for the remaining 85 percent of the capital gain which would have been ordinary income under section 1245 was reduced by 28.4 percent (i.e., will equal 71.6 percent of 18/46 of the gain, or approximately 28 percent of the gain).

(6) *Pollution control facilities.*—Fifteen percent of the basis of pollution control facilities to which an election under section 169 applies was treated as if the election did not apply. The minimum tax preference for the remaining property for which 5-year amortization was elected was reduced by 28.4 percent.

(7) *Intangible drilling costs.*—In the case of an integrated oil company, 15 percent of the amount otherwise allowable as a deduction for intangible drilling costs under section 263(c) was capitalized to the oil, gas or geothermal property and deducted ratably over a 36-month period beginning with the month the costs are paid or incurred.

(8) *Mineral exploration and development costs.*—Fifteen percent of the amounts otherwise allowable as deductions under section 616 and 617 to a corporation were capitalized and treated as if they were used to acquire recovery property assigned to the 5-year class. ACRS deductions were allowed beginning with the year the expenses are paid or incurred, and the investment tax credit was available in the year the expenses are paid or incurred.

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times $39.10, or $5.87), this reduces the total tax benefit from the preference to $24.10 ($39.10 minus $9.13 minus $5.87). Thus, the tax benefit from this taxpayer's marginal dollar of percentage depletion is the same as it was prior to the enactment of section 291.

Reasons for Change

Congress believed that some of the tax preferences enacted over the years should be scaled back further in light of the large budget deficits. For this reason, the present 15-percent cutback was generally increased to 20 percent.

Explanation of Provision

The provision generally increases the 15-percent preference cutback to 20 percent. The benefits of the new FSC legislation in the Act is reduced by approximately 5/85 where there is a corporate FSC shareholder. The cutback in the depletion allowance for coal and iron ore remains unchanged. The 71.6 percent preference inclusion rule for the add-on minimum tax (except for percentage depletion) is decreased to 59 5/6 percent.[40]

Effective Dates

The provision generally applies to taxable years beginning after December 31, 1984.[41] However, the provision (both section 291 and the corresponding changes to section 57) relating to deductions under sections 263(c), 616 and 617 applies to expenditures made after that date; the provision relating to pollution control facilities applies to property placed in service after that date; and the provision relating to section 1250 property applies to dispositions after that date.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $236 million in 1985, $357 million in 1986, $400 million in 1987, $449 million in 1988, and $512 million in 1989.

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[40] The 59 5/6 percent figure is derived as follows: A taxpayer with $100 of excess bad debt reserves received a tax benefit, at the margin, of $24.10 as explained in the previous footnote. Under a 20-percent preference cutback, the deduction is reduced to $80, reducing its regular tax benefit to $36.80 (46 percent times $80). Including only 59 5/6 percent of the preference ($47.87) in the minimum tax reduces the direct minimum tax to $7.18 (15 percent times $47.87). Together with the indirect minimum tax through the reduction in the deduction for regular taxes (15 percent times $36.80, or $5.52), this reduces the total tax benefit of the preference to $24.10 ($36.80 minus $7.18 minus $5.52). Thus the tax benefit from this taxpayer's marginal dollar of excess bad debt reserves will be the same as under pre-1982 law.The reference in section 57(b)(2) to "85 percent" should be changed to "80 percent" to conform to the increased cutback.

[41] The increased cutback with respect to tax-exempt obligations will apply with respect to obligations acquired after 1982.

E. Partnership Provisions

1. Partnership Allocations with Respect to Contributed Property (sec. 71 of the Act and sec. 704 of the Code)[1]

Prior Law

Partnership allocations generally

Under prior and present law, a partner's distributive share of partnership income, gain, loss, deduction, or credit (or items thereof) generally is governed by the partnership agreement. However, if the allocation provided for by the partnership agreement does not have substantial economic effect, these items are reallocated for tax purposes in accordance with the partner's interest in the partnership, determined by taking into account all facts and circumstances. Proposed Treasury regulations provide that, in general, an allocation has economic effect (whether or not substantial) if (1) the allocation is reflected by an appropriate increase or decrease in the partner's capital account, (2) liquidation proceeds (if any) are to be distributed in accordance with the partners' capital account balances, and (3) any partner with a deficit in his capital account following the distribution of liquidation proceeds is required to restore the amount of such deficit to the partnership. The economic effect of the allocation must be substantial in relation to the tax effect for the allocation provided for in the agreement to have substantial economic effect.[2]

Property contributed to a partnership

Under prior law (sec. 704(c)(2)), when property was contributed to a partnership, the partnership could (but was not required to) allocate depreciation, depletion, or gain or loss with respect to the contributed property so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution. If the partnership did not make allocations on this basis, the allocations were made as if the property had been purchased by the partnership.

Under prior law, a shifting of income or losses among partners that did not reflect the economic burdens borne by the parties could occur if a partnership did not elect to allocate depreciation, depletion, and gain or loss with respect to contributed property so as to take account of the variation between the basis and the fair market value of the contributed property. For example, assume

[1] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, section 71; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1208-1210; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, section 55; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 213-216; and H. Rep. No. 98-861 (June 23, 1984), pp. 854-859 (Conference Report).

[2] Prop. Treas. Reg. sec. 1.704-1(b)(2)(ii) and (iii), 48 Fed. Reg. 9871 (March 9, 1983).

that partner A contributed property with a basis of $200 and a value of $100 while partner B contributed $100 in cash to a partnership, and the initial capital accounts of the partners were each set at $100 (the fair market value of their contributions). Under the general rule, it was thought that a subsequent sale of the property for $100 would result in an allocation of $50 of loss to each partner, thereby shifting $50 of loss from A to B. This shifting of the loss could remain effective so long as the partnership remained in existence, although the pre-contribution loss would be effectively reallocated to the contributing partner if his interest in the partnership were liquidated or sold. Generally, it was thought that a similar shifting of gain could be accomplished in the case of a contribution of appreciated property to a partnership.

Reasons for Change

Although Congress believed that the underlying theory of the present law partnership provisions, that taxpayers should be able to pool their resources for productive uses without triggering taxable gain or loss, is appropriate, it also believed that special rules were needed to prevent an artificial shifting of tax consequences between partners with respect to pre-contribution gain or loss. This is particularly important since the various partners may have different tax positions. For example, a partner to whom gain could have been shifted in the absence of the Act's provisions could be tax-exempt, could have a lower marginal rate than the contributing partner, or could have an expiring net operating loss carryover.

Congress was also concerned that the transfer to a partnership of accounts receivable, accounts payable, or other accrued but unpaid items of a partner who uses the cash method of accounting should not result in effectively transferring some or all of the transferor partner's tax benefits or burdens (attributable to the future deduction or income) to other partners.

In addition to the cases described above, Congress was aware of the similar situation which exists when cash is contributed to an ongoing partnership which has property with a value greater than, or less than, its adjusted basis in the hands of the partnership. However, Congress did not provide a new rule in this case because it believed that this issue may have been adequately dealt with in proposed Treas. Reg. section 1.704-1(b)(4)(i) (concerning allocations when there are disparities between tax and book capital accounts).

Explanation of Provision

Overview

The Act makes three changes in the prior law rules relating to allocations with respect to property contributed to a partnership by a partner. First, the Act provides for the mandatory allocation of built-in gain or loss on contributed property in accordance with Treasury regulations. Second, the Act applies comparable allocation rules when accrued, but unpaid items are "contributed" to a partnership by a partner who uses the cash receipts and disbursements method of accounting. Third, the Act repeals the prior law rules relating to allocations with respect to contributions of undivided interests in property.

Contributed property

The Act replaces the prior law elective treatment of allocations with respect to contributed property with a new rule under which items of income, gain, loss, and deduction with respect to contributed property are to be shared among the partners, under Treasury regulations, so as to take account of the difference between the partnership's basis for the property and the fair market value of the property at the time of the contribution. Although Congress intended that partnerships could continue to rely on the regulations issued under former section 704(c)(2) until new regulations are provided, Congress provided authority to modify significantly those rules.[3]

Under the provision, a partnership is generally required, rather than being permitted (as under prior law), to allocate "built-in" gain or loss on contributed property to the contributing partner. In determining the amount of built-in gain or loss, the fair market value of contributed property generally is to be determined by reference to the arm's-length dealings of the various partners as reflected in their capital accounts (if the parties have sufficiently adverse interests). This determination normally will not be upset by the Treasury except in cases of manipulation or abuse. It is anticipated that the regulations may require a partnership to file a statement of the agreed fair market value of contributed property with the partnership return for the year in which the contribution is made.

It was anticipated that Treasury regulations may permit partners to agree to a more rapid elimination of disparities between the value and adjusted basis of contributed property (determined at the time of contribution) among partners than is required by the new rules, by substituting items not described in section 704(c) for items described in section 704(c) and vice versa, provided that there is no tax avoidance potential.[4] Similarly, to limit the burden of recordkeeping requirements for small operating partnerships, if no tax avoidance potential exists, the regulations may permit (1) aggregation of properties with fair market values greater than their respective adjusted basis that are contributed by a single partner; (2) aggregation of properties with fair market values less than their respective adjusted basis that are contributed by a single partner; (3) differences of less than 15 percent (but not exceeding $10,000) between the adjusted basis and the fair market value of any aggregated properties to be accounted for in a manner consistent with section 704(c)(1) as it existed under prior law; and (4) differences between the adjusted basis and the fair market value of contributed

[3] With respect to contributions made before the regulations are proposed, Congress expected that the regulations will provide specifically that the partnership has complied with the requirements of this mandatory allocation if allocations with respect to contributed property were made in accordance with the regulations under section 704(c)(2) of prior law.

[4] In addition, it may be appropriate to amend example (2) of Treas. Reg. section 1.704-1(c)(2) to provide that if the property there is sold for a price exceeding $9,000, the taxable gain represented by the first $200 of such excess would be allocated to partner C. This would allow the effect of the ceiling rule limitations to be offset by subsequent gain allocations.

properties to be eliminated more slowly than required by the new rules through allocations solely of gain or loss on the disposition of such properties (i.e., permitting allocations of depreciation, depletion, or similar items with respect to such property, to be governed solely by section 704(b)), provided that this flexibility is not likely to result in the contributing partner avoiding the effect of the allocation of built-in gain or loss (such as when the property is expected to be held by the partnership until it has little, if any, fair market value).

The examples above were intended by Congress to be illustrative of, rather than a limitation on, the Treasury's authority to provide reasonable rules as long as no abuse potential is present. Thus, although partnerships may continue to rely on the regulations issued under prior law section 704(c)(2) until new regulations are proposed, the Treasury Department has the authority to modify or expand those rules significantly. These modified regulations may take into account situations not addressed by the prior law rules, including those involving contributions of (1) more than one item of property with built-in gain or loss by a single partner (as described above), (2) properties with built-in gain or loss by more than one partner, (3) property with built-in gain that would constitute ordinary income under the various recapture provisions, (4) property which is disposed of by the partnership in exchange for "substituted basis" property as defined in new section 7701(a)(42), (5) property when there are disproportionate profit and loss sharing arrangements contained in the partnership agreement, and (6) property which is not disposed of prior to the contributing partner's disposition of his partnership interest.

Under prior law, an election could be made to allocate depreciation or depletion with respect to contributed property so as to reflect any amount of built-in gain or loss on the contributed property. For example, if in a 50-50 partnership, A contributed property with a fair market value of $100 and a basis of $50 to a partnership and B contributed $100 cash which was used to purchase a depreciable asset, the regulations under prior law permitted AB to elect to allocate depreciation of the $50 basis to B. Such an allocation would be sensible from the viewpoint of A and B. First, if the contributed property will, in fact be exhausted, the allocation is the only mechanism available to compensate B for the fact that he had to contribute value by reference to the property's fair market value rather than its basis. Secondly, the aggregate amount of basis invested in the partnership is $150 ($100 cash plus $50 basis). If depreciation with respect to the purchased property is shared equally ($50 and $50), then A will recover his original contributed basis even with the allocation of depreciation on the contributed property to B. Thus, the allocation of depreciation or depletion was, under prior law, simply one way of eliminating the difference between the value and basis of contributed property. Congress intended that the regulatory authority granted to the Treasury would be construed broadly enough to give the Treasury discretion to permit mandatory allocations of depreciation and depletion when necessary to eliminate a built-in gain or loss, and to permit allocation solely of gain or loss when foregoing an allocation of depletion or depreciation does not create significant avoidance potential.

Congress was aware of special concerns which may arise in applying the new rule to oil and gas property subject to an allowance for depletion. Under prior and present law, a partnership allocates the adjusted basis of an oil or gas property among those who are partners as of the time the property is acquired and also allocates the amount realized from the taxable disposition of such property among the partners. Each partner uses these items to compute separately his depletion deduction and gain or loss with respect to the property. Thus, the partnership does not actually allocate depletion or gain or loss with respect to such property to its partners. It was intended that Treasury regulations will provide for allocations of adjusted basis and amount realized to account for any built-in gain or loss on contributed oil and gas properties, but may permit flexibility in allocating adjusted basis in non-abusive cases consistent with the discussion above.

Accrued but unpaid cash items

The Act authorizes the Treasury to provide for mandatory allocations of items of income and deduction, as well as gain or loss, with respect to contributed property and authorizes the Treasury to prescribe similar rules when a partner using the cash receipts and disbursements method of accounting transfers accounts payable or other accrued but unpaid liabilities to a partnership. By referring to items of income and deduction, it was not intended that Treasury regulations require variations between the basis and fair market value of contributed property to be eliminated by allocations of operating income and loss attributable to the property (other than depreciation, depletion, and similar items). Rather, this expansion of the scope of section 704(c) was intended primarily to address situations in which a cash method partner contributes accounts receivable, accounts payable, or other accrued but unpaid items to a partnership. Thus, for example, if a cash-method taxpayer contributes accounts payable to a partnership the deductions attributable to those items generally are allocated, if possible, to the contributing partner and, if not, are capitalized (see the discussion of retroactive allocations below). Congress intended that, parallel to the amendments recently made to section 357(c) (and contrary to Rev. Rul. 60-345, 1960-2 C.B. 211), these accrued but unpaid items will not be treated as partnership liabilities for purposes of section 752. Congress expected that the Treasury Department will provide regulations which reach a consistent result in situations in which the partnership is on the accrual method of accounting. These changes, and the changes contained in new section 724 (regarding character of gain or loss on disposition of certain contributed property), were not intended to override the anticipatory assignment of income doctrine in those situations in which such doctrine would apply to a cash-method partner's contribution of accrued but unpaid items to a partnership (see, e.g., Rev. Rul. 80-198, 1980-2 C.B. 113 and Rev. Rul. 80-199, 1980-2 C.B. 122, and the cases cited therein). These changes complement, and are consistent with, the modifications to the retroactive allocation provisions adopted by Congress which prevent a cash-method partnership from shifting its accrued deductions to partners who are admitted to the partnership after such deductions are accrued.

Undivided interest

The Act eliminates a prior law rule for the treatment of contributions of undivided interests in property to a partnership by the various owners of the undivided interests. This rule, which allowed the partnership to treat the property as if it had not been contributed to the partnership, is made unnecessary by the requirement to allocate of income, gain, loss, and deduction to reflect the difference between the basis of property and its fair market value at the time of contribution. Moreover, in a case to which the prior law rule would have applied, the regulations will allow taxpayers to allocate depreciation and depletion in the same manner as under prior law (see Treas. Reg. sec. 1.704-1(c)(3)(ii), example 2).

The Act also makes two conforming amendments in sections 613A(c)(7)(D) (relating to percentage depletion) and 743(b) (relating to optional adjustment to the basis of partnership property).

Effective Date

This provision was effective with respect to property contributed to a partnership after March 31, 1984, in taxable years ending after that date. In the case of allocations with respect to items other than depreciation, depletion, and gain or loss, Congress expected that the regulations requiring allocation and describing the method of allocation will take effect no earlier than the date those regulations are proposed.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $4 million in 1984, $61 million in 1985, $147 million in 1986, $178 million in 1987, $240 million in 1988, and $298 million in 1989.

2. Retroactive Allocations (sec. 72 of the Act and sec. 706 of the Code)[5]

Prior Law

General rules

The Tax Reform Act of 1976 amended the partnership provisions to preclude a partner who acquires his interest late in the taxable year from deducting partnership expenses incurred prior to his entry into the partnership ("retroactive allocations" of partnership losses). The 1976 Act provided that when partners' interests change during the taxable year, each partner's share of various items of partnership income, gain, loss, deduction, and credit is to be determined by taking into account each partner's varying interest in the partnership during the taxable year.

Prior law allowed two basic methods for determining the amount of a partnership's income, gain, loss, deduction, and credit that could be allocated to a partner entering during the taxable year. The first method provided for an "interim closing" of the partnership books whenever a new partner enters the partnership. This method traced partnership income, gain, loss, deduction, and credit to the particular segment of the partnership taxable year during which it was paid or incurred. For example, under this method, a partner admitted on December 1 to a partnership using a calendar taxable year would be allocated only his share of items paid or incurred by the partnership during the month of December.

The second allowable allocation method provided for a proration of partnership income, gain, loss, deduction, and credit for the entire taxable year. This proration generally was based on the number of days in the partnership taxable year during which the entering partner was a member of the partnership divided by the total number of days in the partnership taxable year. The entering partner's share of each partnership item for the taxable year was determined by multiplying this fraction by the amount of partnership income, gain, loss, deduction, and credit that the partner would have been allocated had he been a partner for the entire partnership taxable year. For example, a partner admitted on December 1 to a partnership having a calendar taxable year would be allocated 1/12 of his hypothetical share of items for the entire partnership taxable year, regardless of the point during the year at which these expenses were paid or incurred.

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[5] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, section 72; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1211-1215; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, section 56; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 213-222; H. Con. Res. 328, 130 Cong. Rec. S. 8943 (June 29, 1984), H. 7525 (June 29, 1984); and H. Rep. No. 998-861 (June 23, 1984), pp. 854-859 (Conference Report).

The legislative history of the 1976 Act provided that, to avoid undue complexity, Treasury regulations could allow partnerships to use a convention under which changes in partnership interests were accounted for on a semi-monthly basis. No regulations implementing such a convention have been issued.

Techniques for avoiding retroactive allocation rules

Cash basis partnerships

Under prior law, some partnerships attempted to avoid the retroactive allocation rules by using the cash method of accounting and deferring actual payment of deductible items until near the close of the partnership's taxable year. For example, if a partnership deferred the payment of an expense (e.g., interest) until December 31, and the partnership used the interim closing method of allocations, a partner admitted on December 30 was allocated a deduction for a full portion of the expense. This occurred even though the expense had economically accrued at an equal rate throughout the taxable year.

Tiered partnership arrangements

In addition to cash basis partnerships, some taxpayers attempted to avoid the retroactive allocation rules by use of tiered partnership arrangements combined with the interim closing method of allocations. For example, assume that an upper-tier partnership owned a 90-percent interest in a lower-tier partnership and that both the upper-tier and the lower-tier used a calendar taxable year. Assume further that lower-tier had a $10,000 loss for the calendar year, and that the upper-tier's distributive share was 90 percent of this amount or $9,000. Finally, assume that partner A made a contribution to the upper-tier partnership in exchange for an 80-percent interest in the upper-tier partnership at the close of business on December 30, and that the upper-tier made an interim closing of its books on December 31 to determine A's distributive share of the upper-tier's partnership items.

Under prior law, the upper-tier partnership might have taken the position that, for tax purposes, it incurred its entire $9,000 portion of the lower-tier's loss on December 31, i.e., at the close of the lower-tier's taxable year, regardless of when the loss was actually incurred by the lower-tier partnership. Partner A would, therefore, have claimed a $7,200 loss on his return (Parent's $9,000 loss multiplied by his 80-percent interest in the partnership on December 31) rather than the $19.73 that he would have been entitled to under a proportionate share computation (i.e., $9,000 x 80 percent x 1/365 days).

The Internal Revenue Service had taken the position that, in the situation above, losses were sustained by the upper-tier partnership at the same time they were sustained by the lower-tier partnership and that the limitation against retroactive allocations was thus equally applicable to this situation. Rev. Rul. 77-311, 1977-2 C.B. 218. However, under prior law, taxpayers could continue to take a contrary position on their tax returns.

Reasons for Change

The 1976 rules regarding retroactive allocations were enacted to clarify that the law required the inclusion of income and loss according to a partner's varying interests during the taxable year. Legislative history indicates that Congress, in adding these rules, intended to prevent partners investing in a partnership toward the close of the taxable year from deducting expenses which were incurred prior to their entry into the partnership.[6] In adding these rules, Congress rejected the argument that retroactive allocations were proper because the funds invested by the new partners served to reimburse the original partners for their expenditures so that, as an economic matter, the new partners had incurred the costs for which they were claiming deductions. This argument was found unpersuasive when the new partner was compared with an investor directly purchasing property which had generated tax losses earlier in the taxable year; that investor would not be entitled to deduct the losses incurred prior to his ownership of the property.

Congress believed that the policy of the 1976 Act prohibiting retroactive allocations, and the rationale for that policy, remain equally applicable today. Taxpayers should not be able to attempt to avoid the 1976 rules through the use of tiered partnership or other arrangements.

Congress recognized that the use of cash method partnerships raises issues distinct from tiered arrangements, and that the cash method may be appropriate for partnerships in certain circumstances. However, it believed that the cash method should not be used to create deductions for late-entering partners.

Explanation of Provision

General rule

The Act provides a general rule, comparable to that of prior law, that if any partner's interest in a partnership changes at any time during the partnership's taxable year (including changes taking effect at the beginning of the taxable year), each partner's distributive share of items of partnership income, gain, loss, deduction, or credit is to be determined by using any method prescribed by Treasury regulations which takes into account the varying interests of the partners in the partnership during the taxable year. It was anticipated that these regulations will apply the law in a manner consistent with the policies of the Tax Reform Act of 1976 and of the provisions of the Act. Thus, the varying interests rule does not override the longstanding rule of section 761(c) (relating to modifications of partnership agreements) with respect to interest shifts among partners who are members of the partnership for the entire taxable year, provided such shifts are not, in substance, attributable to the influx of new capital from such partners. See *Lipke* v. *Commissioner*, 81 T.C. 689 (1983).

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[6] H. Rep. No. 94-658, 94th Cong. 1st Sess, p. 124 (November 12, 1975); S. Rep. No. 94-938, 94th Cong., 2d Sess., p. 97 (June 10, 1976).

Cash basis partnerships

With respect to partnerships using the cash receipts and disbursements method of accounting, the Act provides new rules for the allocation of items among partners when there is a change in partnership interests. First, for specified cash basis items, the Act requires that each item be assigned to each day in the period to which the item is economically attributable. The amounts so assigned are then to be apportioned among the partners in proportion to their interest in the partnership at the close of each day. These rules (which apply except when Treasury regulations otherwise provide) effectively require that the applicable items be allocated among the partners under the accrual method. The items to which the provision applies (assuming that the partnership accounts for the item under the cash method) are (1) interest, (2) taxes, (3) payment for services or for the use of property, and (4) any other item of a kind specified in Treasury regulations as being an item with respect to which the rule is necessary to avoid significant misstatements of the partners' income.

For example, if a new partner, who has a pro rata share of all partnership items for all relevant periods, joins a calendar-year partnership on December 1, and if the partnership on December 31 pays an interest expense which has accrued over the course of the entire year, the partner would be entitled to 1/12 of his otherwise allocable share of the deduction for that item. If the expense were attributable only to the final 6 months of the year, he would receive 1/6 of his otherwise allocable share of that item. The determination of the period to which an expense is attributable must be made in accordance with economic accrual principles.

The Act provides that when application of the economic accrual principles described above results in attributing an item to periods before or after the current taxable year, those items are to be assigned entirely to the first day of the year (in the case of items attributable to prior years) or entirely to the last day of the year (in the case of items attributable to future periods). This rule does not make any substantive change to the timing of any deduction under the Code; rather, it merely describes the treatment of amounts that are currently deductible even though economically attributable to a past or future year. For example, if a cash method partnership fails to pay for services provided to it in year 1 until the middle of year 2, the amount of the year 2 deduction is allocated to the first day of year 2. Similarly, if the partnership is required to pay property taxes in year 1 for the last half of year 1 and the first half of year 2, the amount attributed to year 2 is treated as paid on the last day of year 1. (Of course, the latter rule has limited application because of the general limitations on the deductibility of prepaid expenses (see section 91 of the Act)).

In the case of items (or portions of items) which are attributable to periods before the beginning of the taxable year, and which are therefore assigned to the first day of the taxable year under the rules above, the items are to be allocated to the persons who were partners during the period to which each item is attributable, in accordance with their varying interests in the partnership during that period (determined in a manner consistent with section 704).

This determination requires allocation of such items in the manner in which the partners would have borne the corresponding economic cost, even if the actual payment is made with funds provided by another partner (typically, a later-admitted partner) in connection with a change in the partners' interests in the partnership (other than a change governed by section 761 rather than section 706). If the persons to whom all or part of such items is allocable are not partners in the partnership on the first day of the partnership taxable year in which the item is taken into account, their portion of such items must be capitalized by the partnership and allocated to the basis of partnership assets in the manner required by section 755. This rule prevents taxpayers from avoiding the retroactive allocation rules by delaying payment of deductible cash-method items until the first day of the year following the year in which a change in partnership interests takes place. The rules above do not affect the taxable year or the tax accounting method of the partnership itself.

Tiered partnerships

The Act requires that, when one partnership (the "upper-tier" partnership) is a member of a second partnership (the "lower-tier" partnership), and there is a change in the interests of the partners in the upper-tier partnership, items of the lower-tier partnership are (except as otherwise provided by regulations) to be allocated among the partners of the upper-tier partnership (1) by assigning the appropriate portion of each item to the appropriate days in the upper-tier partnership's taxable year during which the upper-tier partnership is a partner in the lower-tier partnership (taking into account the rules for allocation of certain cash basis items above), and (2) by allocating the portion assigned to each day among the partners of the upper-tier partnership in proportion to their interests in that partnership as of the close of the day (determined in a manner consistent with section 704). Effectively, under this rule, the existence of the tiered partnership arrangement is ignored for allocation purposes and the items of the lower-tier partnership "flow through" to the partners in the upper-tier partnership in accordance with their effective interests in the lower-tier partnership as of the close of each day.

Items attributable to periods before or after the lower-tier partnership's taxable year are to be accounted for in a manner consistent with the principles applied under the rule regarding cash basis items.

These rules are intended to prevent the use of tiered partnership arrangements to avoid the retroactive allocation rules and generally are consistent with the principles of Rev. Rul. 77-311, 1977-2 C.B. 218.

Other rules

The Act provides for daily apportionment under the cash basis and tiered partnership rules; however Congress recognized that most partnerships do not account for the admission of new partners on a daily basis and that daily apportionment of partnership income and expenses would result in an undue administrative burden. Accordingly, to prevent undue complexity, it was intended that, in any case in which there is a disposition of less than an entire interest in the partnership by a partner (including the entry of a new partner), the partnership may elect to determine the varying interests of the partners by using one or more conventions that treat any changes in any partner's interest in the partnership during a particular month as occurring on one or more specified days of the month. The actual method for applying a convention is to be provided by Treasury regulations. The regulations may deny the use of any convention when the occurrence of significant, discrete events (e.g., a large, unusual gain or loss) would mean that use of the convention could result in significant tax avoidance.

Congress intended that the regulations providing for these conventions will be effective on a prospective basis only.[7] Until these regulations are proposed, and for a reasonable transition period thereafter, it is expected that Treasury will permit any reasonable convention to be used. This may include a method under which any partner entering during a month is treated as entering on the first day of the month, a method under which partners entering during the first 15 days of a month are treated as entering on the first day of the month and partners entering after the 15th of the month are treated as entering on the 16th day of the month, or any other method which is not abusive under the relevant facts and circumstances. As under the general rule, use of a convention is not permitted when the occurrence of significant, discrete events (e.g., a large, unusual gain or loss) would result in significant tax avoidance if the convention is used.

Congress did not intend that any inference be drawn regarding the prior law treatment of either the tiered partnership or cash methods arrangement for attempting to allow retroactive allocations.

Effective Dates

The rule regarding cash basis partnerships was effective for amounts attributable to periods after March 31, 1984. The rule regarding tiered partnerships was effective for amounts paid or accrued by the lower-tier partnership after March 31, 1984.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $50 million in 1985, $75 million in 1986, $100 million in 1987, $100 million in 1988, and $100 million in 1989.

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[7] See 130 Cong. Rec. S. 8417-8418 (June 27, 1984) (colloquy between Sen. Armstrong and Sen. Dole); 130 Cong. Rec. S. 8884 (June 29, 1984) (statement of Sen. Dole).

3. Payments to Partners for Property or Certain Services (sec. 73 of the Act and sec. 707 of the Code)[8]

Prior Law

General background

Under present and prior law, the contribution of property to a partnership in return for a partnership interest is generally a tax-free transaction (section 721). If, instead of contributing property to a partnership, the taxpayer sells property to the partnership, the taxpayer realizes income to the extent of gain on the sale and the partnership is generally required to capitalize the amount of the purchase price, which may be recovered through appropriate depreciation or amortization deductions.

When services are provided to a partnership by a nonmember, the partnership may generally deduct amounts paid or incurred for such services (unless such expenses are required to be capitalized), and the party providing services must include an equivalent amount in income. This rule also applies to services provided by a partner acting in a capacity other than as a member of the partnership.

When a partnership allocates income from partnership operations among its partners, the partners generally include these amounts in income in the year with or within which the partnership's taxable year ends. This is distinct from a distribution of partnership assets, which is generally tax-free to the extent that the amount distributed does not exceed the recipient partner's basis for his partnership interest. This tax-free treatment of distributions is based, in part, on the theory that a partner is entitled to withdraw his investment in a partnership (including partnership income on which he has already paid tax) before recognizing gain on the investment.

Although amounts allocated to a partner are not deductible by the partnership, an allocation of taxable income to one partner may have the effect of a deduction for the remaining partners by reducing the amount of taxable income allocated to them.

Avoidance of capitalization and other requirements for payments for property or services

A partnership, like any taxpayer, is generally required to capitalize (rather than currently deduct) expenditures which relate to the improvement of property or which create an asset the useful life of

[8] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, section 73; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1216-1221; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, section 57; S. Rpt. 98-169, Vol. I (April 2, 1984), pp. 223-232; and H. Rep. No. 98-861 (June 23, 1984), pp. 859-862 (Conference Report).

which extends substantially beyond the end of the taxable year. Prior and present law (sec. 709) provide specifically that a partnership may not currently deduct amounts paid or incurred to organize the partnership. Instead, the partnership is permitted an election to deduct these amounts ratably over a 5-year period. Alternatively, the partnership may capitalize these expenses. This denial of current deductions for organizational expenses was made explicit by the Tax Reform Act of 1976. In addition, neither the partnership nor any partner is ever permitted to deduct partnership syndication expenses.

Under prior law, if the organizer or syndicator of a partnership was also a general partner of the partnership, allocations of partnership gross or net income to the organizer and related income distributions to him in payment for his services could, if recognized, have the effect of a current deduction for organizational and syndication fees despite the rules above. This could result because the allocation and related distribution (which in this case were economically indistinguishable from a direct payment), reduced the taxable income allocated to the remaining partners in the year of the allocation, resulting in an effective deduction by these partners. The capitalization requirement for other types of capital expenditures could also arguably be avoided by this type of arrangement. Similarly, if a service-providing partner was allocated a portion of the partnership's capital gains in lieu of a fee, the effect of the allocation/distribution could be to convert ordinary income (compensation for services) into capital gains.

Under prior law, if amounts were paid or incurred to a partner who engaged in a transaction with the partnership in a capacity other than as a member of the partnership, or if guaranteed payments were made to a partner for services or for the use of the partner's capital, capitalization was required to the same extent as for comparable payments to a non-partner. Some courts, however, had held that payments to a partner based on a percentage of partnership gross income generally were not to be regarded as guaranteed payments. *Pratt* v. *Commissioner*, 64 T.C. 203 (1975), *aff'd in part and rev'd in part,* 550 F.2d 1023 (5th Cir. 1977).

Disguised sales

Under prior and present law, gain or loss generally is not recognized on the contribution of property to a partnership in return for a partnership interest (section 721). Additionally, distributions of money from a partnership to a partner are generally tax-free to the extent of the adjusted basis of the recipient partner's interest in the partnership (section 731). However, the partner must reduce the basis of his partnership interest by the amount of money received (thereby deferring tax until he disposes of the interest).

Treasury regulations provide that, if a transfer of property by a partner to a partnership results in the receipt by the partner of money or other consideration, including a promissory obligation fixed in amount and time for payment, the transaction is to be treated as a sale or exchange rather than a contribution, resulting in tax being imposed in the year of the transaction (Treas. Reg. sec. 1.721-1(a)). These regulations state that the substance of the transaction, rather than its form, is to govern in such cases. Treasury regulations also provide that if a contribution of property is made to a partnership and (1) within a short time before or after such contribution other property is distributed to the contributing partner and the contributed property is retained by the partnership, or (2) within a short time after such contribution to the partnership, the contributed property is distributed to another partner, tax-free distribution treatment may not apply. These regulations further state that tax-free treatment does not apply if a purported distribution is, in fact, made to effect an exchange of property between two or more of the partners or between the partnership and a partner (Treas. Reg. sec. 1.731-1(c)(3)). Based on these regulations, the Internal Revenue Service has argued that a contribution of cash by one partner followed by a distribution of cash to another partner should be recharacterized as a sale of an interest in the partnership.

The rules above did not always prevent de facto sales of property to a partnership or another partner from being structured as a contribution to the partnership, followed (or preceded) by a tax-free distribution from the partnership. For example, under the case law, partner A could contribute $50,000 in cash to a partnership and partner B could contribute property with a basis of $50,000 and a fair market value of $100,000 to the partnership as an equal partner. If the partnership then transferred $50,000 in cash to partner B, based on the case law, it would not have been unreasonable for partner B to claim that this $50,000 represented a distribution not exceeding his basis in the partnership and for which he was therefore not subject to tax. (The basis for partner B's interest in the partnership would then be reduced from $50,000 to $0.) If this result were permitted, partner B could defer or avoid tax on a transaction that closely resembles a sale of property to the partnership (or a partial sale to partner A followed by a joint contribution). Case law permitted this result, despite the regulations described above, in cases which were economically indistinguishable from a sale of all or part of the property. See *Otey* v. *Commissioner*, 70 T.C. 312 (1978), *aff'd per curiam*, 634 F.2d 1046 (6th Cir. 1980); *Communications Satellite Corp.* v. *United States*, 625 F.2d 997 (Ct. Cl. 1980); *Jupiter Corp.* v. *United States*, 2 Cl. Ct. 61 (1983).

Reasons for Change

Congress was concerned that partnerships had been used effectively to circumvent the requirement to capitalize certain expenses, and other rules and restrictions concerning various types of expenses, by making allocations of income and corresponding distributions in place of direct payments for property or services. Congress believed that these transactions must be expressly prohibited if the integrity of the capitalization requirements of prior and present law is to be preserved. For example, in *Ellison* v. *Commissioner*, 80 T.C. 378 (1983), the Tax Court rejected use of a similar technique to convert purchase price into the equivalent of a deductible expense, concluding that, when the seller of property to a partnership retained an interest in a specified portion of the income from property, the interest retained by the seller was in reality a disguised purchase price.

In the case of disguised sales, Congress was concerned that taxpayers had deferred or avoided tax on sales of property (including partnership interests) by characterizing sales as contributions of property (including money) followed, or preceded, by a related partnership distribution. Although Treasury regulations provide that the substance of the transaction should govern, court decisions had allowed tax-free treatment in cases which were economically indistinguishable from sales of property to a partnership or another partner. Congress believed that these transactions should be treated for tax purposes in a manner consistent with their underlying economic substance.

Explanation of Provisions

Overview

The Act adopts two new rules under which transactions which purport to be between a partner and the partnership are treated as occurring between a third party and the partnership or directly between the partners as third parties. In providing these new rules, Congress was mindful that to be considered partners for tax purposes, persons must, among other things, pool their assets and labor for the joint production of profit. To the extent that a partner's profit from a transaction is assured without regard to the success or failure of the joint undertaking, there is not the requisite joint profit motive, and the partner is acting as a third party.

The Act provides explicitly that this partner-nonpartner distinction is to apply when a partner (or a purported partner) receives money or property in a third party capacity even though the transfer to the partner is cast as an allocation and distribution of partnership income or as a distribution of partnership assets.

Recharacterization of certain payments cast as allocations and distributions

The Act provides that, under Treasury regulations, if (1) a partner performs services for, or transfers property to, a partnership, (2) there is a related direct or indirect partnership allocation and distribution to the partner, and (3) when viewed together, the performance of such services (or the transfer of such property) and the allocation/distribution are properly characterized as a transaction between the partnership and a partner acting in a non-partner capacity, the transaction is to be treated as a transaction between the partnership and a person who is not a partner. In such a case, the amount paid to the partner in consideration for the property or services is treated as a payment for services or property provided to the partnership (as the case may be), and, where appropriate, the partnership must capitalize these amounts (or otherwise treat such amounts in a manner consistent with their recharacterization). The partnership must also treat the purported allocation to the partner performing services or transferring property to the partnership as a payment to a non-partner in determining the remaining partners' shares of taxable income or loss.

Congress did not intend that this provision apply in every instance in which a partner acquires an interest in a partnership and also performs services for or transfers property to the partnership.

In particular, Congress did not intend to repeal the general rule under which gain or loss is not recognized on a contribution of property in return for a partnership interest (section 721),[9] or to apply this new provision in cases in which a partner receives an allocation (or an increased allocation) for an extended period to reflect his contribution of property or services to the partnership and the facts and circumstances indicate that the partner is receiving the allocation in his capacity as a partner. However, Congress did intend that the provision apply to allocations which are determined to be related to the performance of services for, or the transfer of property to, the partnership and which, when viewed together with distributions, have the substantive economic effect of direct payments for such property or services under the facts and circumstances of the case.

The Act authorizes the Treasury Department to prescribe such regulations as may be necessary or appropriate to carry out the purposes of the provision. In prescribing these regulations, the Treasury should be mindful that Congress is concerned with transactions that work to avoid capitalization requirements or other rules and restrictions governing direct payments and not with nonabusive allocations that accurately reflect the various economic contributions of the partners. These regulations may apply the provision both to one-time transactions and to continuing arrangements which utilize purported partnership allocations and distributions in place of direct payments. Congress specifically intended that the provision apply to allocations used to pay partnership organization or syndication fees, subject to the general principles above.

The regulations will provide, when appropriate, that the purported partner performing services for or transferring property to the partnership is not a partner at all for tax purposes. If it is determined that the service performer or property transferor actually is a partner (because of other transactions), Congress believed that the factors described below should be considered in determining whether the partner is receiving the putative allocation and distribution in his capacity as a partner.

The first, and generally the most important, factor is whether the payment is subject to an appreciable risk as to amount. Partners extract the profits of the partnership with reference to the business success of the venture, while third parties generally receive payments which are not subject to this risk. Thus, an allocation and distribution provided for a service partner under the partnership agreement which subjects the partner to significant entrepreneurial risk as to both the amount and the fact of payment generally should be recognized as a distributive share and a partnership distribution, while an allocation and distribution provided to a service partner under the partnership agreement which involve limited risk as to amount and payment should generally be treated as a fee under section 707(a). Examples of allocations that limit a

[9] Of course, if a partner received an interest in a partnership in exchange for services, he may recognize income upon that receipt; however, this issue arises only if it is determined that an amount received is not a fee but relates instead to a partnership interest. See Code sections 61 and 83; *Diamond* v. *Commissioner*, 492 F.2d 286 (7th Cir. 1974).

partner's risk include both "capped" allocations of partnership income (i.e., percentage or fixed dollar amount allocations subject to an annual maximum amount when the parties could reasonably expect the cap to apply in most years) and allocations for a fixed number of years under which the income that will go to the partner is reasonably certain. Similarly, continuing arrangements in which purported allocations and distributions (under a formula or otherwise) are fixed in amount or reasonably determinable under all the facts and circumstances and which arise in connection with services also shield the purported partner from entrepreneurial risk. Although short-lived gross income allocations are particularly suspect in this regard, gross income allocations may, in very limited instances, represent an entrepreneurial return, which is classifiable as a distributive share under section 704. Similarly, although net income allocations appear generally to constitute distributive shares, some net income allocations may be fixed as to amount and probability of payment and should, if coupled with a distribution or payment from the partnership, be characterized as fees.

The second factor is whether the partner status of the recipient is transitory. Transitory partner status (which limits the duration of a purported joint undertaking for profit) suggests that a payment is a fee or is in return for property. The fact that partner status is continuing, however, is of no particular relevance in establishing that an allocation and distribution are received in an individual's capacity as a partner.

The third factor is whether the allocation and distribution that are made to the partner are close in time to the partner's performance of services for or transfer of property to the partnership. An allocation close in time to the performance of services, or the transfer of property, is more likely to be related to the services or property. In the case of continuing arrangements, the time at which income is scheduled to be allocated to the partner may be a factor indicating that an allocation is, in fact, a disguised payment. When the income subject to allocation arises over an extended period or is remote in time from the services or property contributed by a partner, the risk of not receiving payment (the first factor described above) may also increase.

The fourth factor is whether, under all the facts and circumstances, it appears that the recipient became a partner primarily to obtain tax benefits for himself or the partnership which would not have been available if he had rendered services to the partnership in a third party capacity. The fact that a partner also has significant non-tax motivations in becoming a partner is of no particular relevance.

The fifth factor, which relates to purported allocations/distributions for services, is whether the value of the recipient's interest in general and continuing partnership profits is small in relation to the allocation in question (thus suggesting that the purported allocation is, in fact, a fee). This is especially significant if the allocation for services is for a limited period of time. The fact that the recipient's interest in general and continuing partnership profits is substantial does not, however, suggest that the purported partnership allocation/distribution arrangement should be recognized.

The sixth factor, which relates to purported allocations/distributions for property, is whether the requirement that capital accounts be respected under section 704(b) (and the proposed regulations thereunder) makes income allocations which are disguised payments for capital economically unfeasible and therefore unlikely to occur. This generally will be the case unless (i) the valuation of the property contributed by the partner to the partnership is below the fair market value of such property (thus improperly understating the amount in such partner's capital account), or (ii) the property is sold by the partner to the partnership at a stated price below the fair market value of such property, or (iii) the capital account will be respected at such a distant point in the future that its present value is small and there is to be no meaningful return on the capital account in the intervening period.

Congress anticipated that the Treasury Department may describe other factors that are relevant in evaluating whether a purported allocation and distribution should be respected. In applying these various factors, the Treasury and the courts should be careful not to be misled by possibly self-serving assertions in the partnership agreement as to the duties of a partner in his partner capacity but should instead seek to determine the substance of the transaction.

In the case of allocations which are only partly determined to be related to the performance of services for, or the transfer of property to, the partnership, the provision applies to that portion of the allocation which is reasonably determined to be related to the property or services provided to the partnership. Finally, it was anticipated that Treasury regulations will provide for the coordination of this provision with the preexisting rules of section 707 and other provisions of subchapter K such as section 736.

Congress did not intend to create any inference regarding the tax treatment of the transactions described above under prior law.

The principles of this provision can be illustrated by the following examples.

Example 1

A commercial office building constructed by a partnership is projected to generate gross income of at least $100,000 per year indefinitely. Its architect, whose normal fee for such services is $40,000, contributes cash for a 25-percent interest in the partnership and receives both a 25-percent distributive share of net income for the life of the partnership, and an allocation of $20,000 of partnership gross income for the first two years of partnership operations after lease-up. The partnership is expected to have sufficient cash available to distribute $20,000 to the architect in each of the first two years, and the agreement requires such a distribution.

The purported gross income allocation and partnership distribution in this example should be treated as a fee under section 707(a), rather than as a distributive share because as to those payments the architect is insulated from the risk of the joint enterprise. Factors which contribute to this conclusion are (1) the special allocation to the architect is fixed in amount and there is a substantial probability that the partnership will have sufficient gross income and cash to satisfy the allocation/distribution; (2) the distribution relating to the allocation is fairly close in time to the rendering of the services; and (3) it is not unreasonable to conclude from all the facts and circumstances that the architect became a partner primarily for tax reasons.

If, on the other hand, the agreement allocates to the architect 20 percent of gross income for the first two years following construction of the building, a question arises as to how likely it is that the architect will receive substantially more or less than his imputed fee of $40,000. If the building is pre-leased to a high credit tenant under a lease requiring the lessee to pay $100,000 per year of rent, or if there is low vacancy rate in the area for comparable space, it is likely that the architect will receive approximately $20,000 per year for the first two years of operations. Therefore, he assumes limited risk as to the amount or payment of the allocation and, as a consequence, the allocation/distribution should be treated as a disguised fee. If, on the other hand, the project is a "spec building," and the architect assumes significant entrepreneurial risk that the partnership will be unable to lease the building, the special allocation might (even though a gross income allocation), depending on all the facts and circumstances, properly be treated as a distributive share and a genuine partnership distribution.

Example 2

In certain instances, allocation/distribution arrangements that are contingent in amount may nevertheless be recharacterized as fees. Generally, these situations should arise only when (1) the partner in question normally performs, has previously performed, or is capable of performing similar services for third parties, and (2) the partnership agreement provides for an allocation and distribution to such partner that effectively compensates him in a manner substantially similar to the manner in which the partner's compensation from third parties normally would be computed.

For example, suppose that a partnership is formed to invest in stock. The partnership admits a stock broker as a partner. The broker agrees to effect trades for the partnership without the normal brokerage commission. In exchange for his partnership interest, the broker contributes 51 percent of partnership capital and receives a 51 percent interest in residual partnership profits and losses. In addition, he receives an allocation of gross income that is computed in a manner which approximates his foregone commissions. It is expected that the partnership will have sufficient gross income to make this allocation. The agreement provides that the broker will receive a priority distribution of cash from operations up to the amount of the gross income allocation. In this case, even though the broker/partner's special allocation appears contingent and not substantially fixed as to amount, it is computed by means of a formula like a normal brokerage fee and effectively varies with the value and amount of services rendered rather than with the income of the partnership. Thus, this contingent gross income allocation along with the equivalent priority distribution should be treated as a fee under section 707(a), rather than as a distributive share and partnership distribution.

In addition to these examples, Congress intended that the provision lead to the conclusions contained in Revenue Ruling 81-300, 1981-2 C.B. 143, and Revenue Ruling 81-301, 1981-2 C.B. 144, except that the transaction described in Revenue Ruling 81-300 would be treated as a transaction described in section 707(a) (rather than section 707(c)).

Disguised sales

The Act provides that, under Treasury regulations, if (1) a partner transfers money or other property (directly or indirectly) to a partnership, (2) there is a related direct or indirect transfer of money or other property by the partnership to that partner (or another partner), and (3) when viewed together, the transfers described above are properly characterized as a sale of property, the transaction is to be treated (as appropriate) as a transaction between the partnership and a non-partner or as a transaction between two or more partners acting in non-partnership capacities. Thus, the transaction is effectively treated either as a sale between the partners of property (including partnership interests), or as a partial sale and a partial contribution of the property to the partnership. In each case, the selling partner is required to recognize gain (or loss) on the amount of the sales proceeds treated as received in the transaction. This rule is intended to prevent the parties from characterizing a sale or exchange of property as a contribution to the partnership followed by a distribution from the partnership and thereby to defer or avoid tax on the transaction.

To accomplish this, the Act authorizes the Treasury Department to prescribe such regulations as may be necessary or appropriate to carry out the purposes of this provision. In prescribing these regulations, Congress wanted Treasury to be mindful of its concern with transactions that attempt to disguise a sale of property and not with non-abusive transactions that accurately reflect the various economic contributions of the partners. Similarly, Congress did not intend to change the general rules concerning the tax treatment of the partners under sections 721, 731, and 752 to the extent that (1) contributed property is encumbered by liabilities not incurred in anticipation of the contribution,[10] or (2) contributions to a partnership which, because of liabilities of the partnership incurred other than in anticipation of the contribution, result in a deemed distribution under section 752(b).

It was anticipated that Treasury regulations will apply the disguised sale provision when the transfer of money or property from the partnership to the partner is related to the transfer of money or other property to the partnership in such manner that, taking into account all the facts and circumstances, the transaction is properly characterized as a sale or exchange of all or part of the property (including an interest in the partnership). For example, when a partner contributes appreciated property to a partnership and receives a distribution of money or property within a reasonable period before or after such contribution, which money or property is approximately equal in value to the portion of contributed property that is in effect given up to the other partner(s), the transaction will be subject to the provision. (The distribution is not sub-

[10] Of course, assumption of liabilities not incurred in anticipation of the contribution may suggest a disguised sale when the contributing partner would have been forced to repay the debt within a short time had the liability not been assumed and paid by the partnership.

ject to the disguised sale rule if there is a corresponding partnership allocation of income or gain; however, that arrangement may instead be subject to the new provision relating to partnership payments for property or services described above.) The disguised sale provision also applies to the extent that (1) the transferor partner receives the proceeds of a loan related to the property and responsibility for the repayment of the loan rests, directly or indirectly, with the partnership (or its assets) or the other partners, or (2) the partner has received a loan related to the property in anticipation of the transaction and responsibility for repayment of the loan is transferred, directly or indirectly, to the partnership (or its assets) or the other partners. When a partner contributes property to a partnership and that property is borrowed against, pledged as collateral for a loan, or otherwise refinanced, and the proceeds of the loan are distributed to the contributing partner, there is not a disguised sale to the extent the distributed proceeds are attributable to indebtedness properly allocable to the contributing partner under the rules of section 752 (i.e., to the extent the contributing partner is considered to retain substantive liability for repayment of the borrowed amounts), since, in effect, the partner in this case has simply borrowed through the partnership. However, to the extent the other partners directly or indirectly (as through the exposure of their share of partnership asset) bear the risk of loss with respect to the borrowed amounts, this may constitute a payment to the contributing partner.

As in the case of the rule regarding payments for services or property, further factors indicating the existence of a disguised sale include the closeness in time of the distribution to the partner and the purported contribution of property by that partner, and the apparent tax motivation of the contributor of property in structuring the transaction as a contribution of property to the partnership. However, the existence of significant non-tax motivations for becoming a partner is of no particular relevance in establishing that a transaction is not a disguised sale. Treasury regulations may provide for a period, such as three years, during which contributions by and distributions to the same or another partner normally will be presumed to be related for purposes of the disguised sale rule.

Although the disguised sale rule applies to sales of property to the partnership, Congress did not intend to prohibit a partner from receiving a partnership interest in return for contributing property which interest entitles him to priorities or preferences as to distributions (such as a preference in nature of interest on contributed property), but which transaction is not in substance a disguised sale. Similarly, Congress generally did not intend this provision to adversely affect distributions that create deficit capital accounts (maintained in a manner consistent with Treasury regulations under section 704(b)) for which the distributee is liable, regardless of the timing of the distribution, unless such deficit capital account is improperly understated or is not expected to be made up until such a distant point in the future that its present value is small. (If this deficit-creating distribution is coupled with an allocation of income or gain, the distribution/allocation arrangement may be subject to the provision relating to partnership payments for services or property.) As indicated, the contribution of encumbered property to a partnership would also not suggest a disguised sale to the extent responsibility for the debt is not shifted, directly or indirectly, to the partnership (or its assets) or to the non-contributing partners.

Congress anticipated that Treasury regulations will treat transactions to which the disguised sale provision applies as a sale of all or a portion of property (or partnership interests), with attendant tax consequences, depending upon the underlying economic substance of the transaction. It was further anticipated that the regulations will take into account the effect of liabilities which may accompany effective sales of property to a partnership or to another partner.

No inference regarding the tax treatment of contribution arrangements or any similar transactions under existing law should be drawn from Congress's action in adopting the disguised sale provision.

Definition of partner

For purpose of the provisions above, the regulations should provide rules for when persons who formally become partners after performing services for, or transferring property to, the partnership are to be treated as partners at the time of the provision of services or transfer of property.

Effective Dates

The provision with respect to services performed for, or property transferred to, a partnership when there is a related allocation and distribution was effective for services performed on property transferred after February 29, 1984.

The disguised sale rule generally applies to property transferred after March 31, 1984, with two exceptions. First, the Act provides a transitional rule for purposes of the disguised sale provision under which prior law applies to a contribution of property before December 31, 1984, if (1) the transfer was proposed in a written private placement offering memorandum circulated before February 28, 1984, (2) there had been incurred more than $250,000 in out-of-pocket costs with respect to the offering as of February 28, 1984, (3) the partner contributing the encumbered property is the sole general partner, and (4) all of the encumbrances incurred in anticipation of the contribution are without recourse to the partnership or to any partner. Second, a transitional rule applies to any transfer of property pursuant to a contract which was a binding contract on March 31, 1984, and at all times thereafter before the transfer.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $20 million in 1985, $51 million in 1986, $60 million in 1987, $69 million in 1988, and $78 million in 1989.

4. Character of Gain or Loss on Disposition of Contributed Property (sec. 74 of the Act and sec. 735 and new sec. 724 of the Code)[11]

Prior Law

The character of income or loss from the disposition of property by a partnership is generally determined at the partnership level.

Under prior law, a contribution of property to a partnership by a partner, followed by a sale of the property, may have resulted in a character of gain or loss different from that which would have resulted from a direct sale by the partner. Thus, ordinary income could be converted into capital gain when dealer status existed at the partner but not at the partnership level. For example, a taxpayer having appreciated inventory could convert the gain on such property from ordinary income to capital gains by contributing the inventory property to a partnership and having the partnership sell the property. Conversely, a capital loss could be converted into an ordinary loss when dealer status existed at the partnership but not the partner level. For example, a taxpayer owning securities which had declined in value could attempt to convert his capital losses into ordinary losses by contributing the securities to a dealer partnership and claiming that the loss upon a later sale of the securities was incurred in the ordinary course of the partnership's trade or business.

This result was in contrast to the treatment, under prior and present law, of certain ordinary income property distributed by a partnership and subsequently sold by the recipient. The character of gain or loss on property in such a case generally is determined by the character of the property in the hands of the distributee with two exceptions. First, in the case of certain inventory items, the ordinary income character of an asset in the hands of the partnership carries over to the partner for a 5-year period. Second, the ordinary income character of certain unrealized trade or business receivables also carries over to the partner on an indefinite basis (section 735).

Reasons for Change

Congress was concerned that, under some circumstances, a taxpayer could alter the character of gain or loss under prior law merely by contributing property to a new or existing partnership. In particular, the conversion of capital to ordinary losses by con-

[11] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, section 74; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1222-1224; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, section 74; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 233-235; and H. Rep. No. 98-861 (June 23, 1984), pp. 862-863 (Conference Report).

tributing securities to a dealer partnership allowed a taxpayer to receive the benefits of capital gain taxation on appreciated securities (by selling them individually) while deducting ordinary losses on the sale of securities which had declined in value (by having the dealer partnership sell them and allocate the resulting loss to the taxpayer). Congress believed that these potential abuses should be prevented by preserving the pre-contribution character of contributed (or substituted basis) property in appropriate cases.

For similar reasons, Congress believed the prior law rules preserving the character of certain property distributed by a partnership (section 735) and the new rules for contributed property should apply to property the basis of which is determined by reference to the distributed property (i.e., substituted basis property).

Explanation of Provision

Under the Act (new sec. 724), if a partnership disposes of property which was inventory property in the hands of a partner immediately before its contribution, any gain or loss recognized by the partnership on the disposition of the property for a period of 5 years after the date of the contribution is treated as ordinary income or loss. Gain or loss on a disposition of unrealized receivables contributed by a partner is treated as ordinary income or loss regardless of the date of disposition. These rules generally mirror the prior and present law treatment of unrealized receivables and inventory distributed to a partner by a partnership and later disposed of by the partner. The Act further provides that built-in losses on capital assets retain their character as capital losses for a period of 5 years after the date of contribution, but only to the extent of pre-contribution unrealized losses.

To prevent avoidance of these rules by exchanging items of property, the Act provides that if contributed property subject to any of the rules is transferred in a nonrecognition transaction, any substituted basis property resulting from the transaction (including the property contributed to the partnership), whether held by the transferor-partnership or by a transferee, is subject to the same characterization rules as the transferred property, and that substitute basis property is (for purposes of these rules) treated as unrealized receivables or as inventory. These rules also apply in the case of subsequent nonrecognition transactions involving the substituted basis property. Similar "basis-tainting" rules are provided in the provisions of prior and present law regarding certain ordinary income property distributed by a partnership to a partner (section 735). It was intended that the basis-tainting rules regarding contributed and distributed property apply only for the period during which the underlying rules would apply if the property were not disposed of in a nonrecognition transaction. For example, if capital loss property were contributed to a partnership and subsequently disposed of in a nonrecognition transaction, capital loss treatment applies to any substituted basis property only for the duration of the 5-year period beginning on the date of the original contribution. An exception to the basis-tainting rules under new section 724 and section 735 is provided for stock in a corporation which is received in a section 351 exchange.

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For purposes of the rules regarding contributed and distributed property (i.e., new sec. 724 and sec. 735), the terms "unrealized receivable" and "inventory item" are generally defined as they are for purposes of section 751 (relating to certain amounts received in exchange for partnership interests); however, application of the rules is not limited (as is section 751) to substantially appreciated inventory. The Act further provides that, for purposes of section 724 and section 735 (but not section 751), certain property which would have qualified as a capital asset if held for one year or more by the partner or partnership prior to contribution or distribution of the property (as the case may be) is not treated as ordinary income property. This change prevents property which would have qualified for capital gain treatment if held by its original owner from receiving less favorable treatment following the transfer of the property.

Effective Date

The provisions regarding contributed property (new section 724) apply to property contributed to a partnership after March 31, 1984, in taxable years ending after that date.

The amendments to the provisions regarding property distributed by a partnership (sec. 735) apply to property distributed after March 31, 1984, in taxable years ending after that date.

Revenue Effect

This provision is estimated to increase fiscal years budget receipts by $24 million in 1985, $63 million in 1986, $66 million in 1987, $67 million in 1988, and $69 million in 1989.

5. Transfers of Partnership and Trust Interests by Corporations; Determination of Fair Market Value (sec. 75 of the Act and secs. 761, 7701, and new sec. 386 of the Code)[12]

Prior Law

Under prior and present law, the gain or loss on the sale or exchange of a partnership interest is generally a capital gain or loss. However, money or property received by a transferor partner in exchange for all or part of his partnership interest is subject to ordinary income treatment to the extent it is attributable to certain ordinary income assets of the partnership (section 751). For purposes of this provision, ordinary income items include the recapture of depreciation deductions previously taken on partnership property.

Also under prior and present law, when a corporation distributes property (or sells property in the course of certain complete liquidations), income attributable to recapture property (and certain installment obligations) is taxed to the corporation, while other gain attributable to appreciation in value of the transferred property generally goes unrecognized.[13]

Some taxpayers contended that the prior law recapture provisions did not apply to the distribution or liquidating sale by a corporation of an interest in a partnership that holds recapture property. According to this interpretation, a corporation could avoid recapture by contributing recapture property to a partnership and distributing interests in the partnership to its shareholders, or selling the interests in the course of liquidation. Taxpayers contended that the partnership interests themselves did not constitute recapture property and that, in any event, a corporate liquidation did not constitute an exchange under section 741. Thus it was argued that no gain was recognized on the transaction. The United States Claims Court in *Holiday Village Shopping Center* v. *United States*, 5 Ct. Cl. 566 (1984) rejected these arguments and held that the recapture provisions were applicable to the distribution of a partnership interest.

Basis adjustments.—Under prior and present law (secs. 743 and 754), a partnership may elect on a sale or exchange (or transfer by reason of death) of interests in the partnership to adjust the basis of partnership assets to reflect differences (1) between the basis of a partner's interest in the partnership and (2) the partner's share of the basis of the partnership property. The election must apply to

[12] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, section 75; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1225-1227; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, section 59; S. Prt. 98-169, Vol. 1 (April 2, 1984), pp. 236-238; and H. Rep. No. 98-861 (June 23, 1984), pp. 863-865 (Conference Report).

[13] Section 311(d) was amended by Act section 54 to require the recognition of gain in most nonliquidating distributions.

all sales or exchanges of partnership interests and may be revoked only for sufficient reason (Treas. Reg. sec. 1.754-1(c)).

Reasons for Change

The corporate recapture rule described above is intended to ensure that corporate income is recognized on a distribution of recapture property to a corporations' shareholders or upon a liquidating sale of such property. Similarly, the requirement that a taxpayer recognize ordinary income on sales or exchanges of certain partnership interests prevents taxpayers from avoiding ordinary income taxation by transferring interests in partnerships which hold assets that would be subject to depreciation recapture (or otherwise subject to ordinary income treatment) if the assets themselves were disposed of.

If an interest in a partnership which holds recapture property could be distributed, or sold in liquidation, without being subject to recapture, the corporation would have effectively deferred (and perhaps avoided) the imposition of recapture tax. Thus, the corporation would have benefitted from the tax advantages of depreciation (including accelerated depreciation) without being subject to recapture as would the case if the corporation distributed the recapture property directly to its shareholders. Congress believed that in this case, as elsewhere, the use of a partnership form should not result in greater tax benefits than would be available in the case of direct ownership.

Explanation of Provision

For purposes of determining the amount (and character) of gain recognized by a corporation on any distribution or liquidating sale or exchange of a partnership interest, the Act (new sec. 386) treats the distribution (or sale or exchange) of a partnership interest as a distribution (or sale or exchange) of the corporation's proportionate share of the recognition property of the partnership. Recognition property is defined as any property with respect to which the corporation would recognize gain if it distributed the property in a distribution (section 311 or 336) or sold the property in a liquidating sale (section 337). The corporation's proportionate share of recognition property is to be determined in accordance with the principles of section 751. The corporation thus is treated as if it had made a direct distribution (or liquidating sale or exchange) of the underlying recognition property for purposes of determining the amount (and character) of gain recognized on the transaction.

The Act further provides that, in determining whether property of a partnership is recognition property, the partnership is to be treated as owning its proportionate share of the property of any other partnership in which it is a partner. This rule is intended to prevent avoidance of the rules above by the use of tiered or multi-tiered partnership arrangements (see item 6. following).

The Act provides that, under Treasury regulations, rules similar to the rules above shall apply in the case of corporate distributions (or liquidating sales or exchanges) of interests in trusts. These rules will prevent the use of interests in trusts to achieve results similar to those prevented by the statute in the case of partnership interests.

No inference is to be drawn from Congress's action regarding the treatment of the transactions described above under prior law.

Basis adjustments.—The Act provides that, for purposes of the optional adjustment to the basis of partnership property under section 743, any distribution of a partnership interest is to be treated as an exchange of that interest. Thus, the basis of partnership property will be adjusted to reflect amounts recognized on transfers of partnership interests accomplished through distributions (whether by corporations or partnerships) as well as those accomplished by ordinary sales or exchanges. The Act further provides that distributions of partnership interests not otherwise treated as exchanges are to be treated as exchanges of such partnership interests for purposes of section 708 (relating to continuation of a partnership) and any other partnership provision of the Code (Subchapter K) which is specified in Treasury regulations. This provision is not intended to treat the distribution of assets that do not constitute a partnership interest as an exchange of partnership interests for purposes of sections 708 and 743. It was intended that the Treasury regulations be consistent with the policy of this provision and the other partnership provisions of the Act.

Determination of fair market value.—The Act includes a general rule clarifying that, for purposes of the income tax provisions of the Internal Revenue Code (Subchapter A), in determining the amount of gain or loss (or deemed gain or loss) with respect to any property, the fair market value of such property is to be treated as being not less than the amount of any nonrecourse indebtedness to which the property is subject. This provision is to be limited in application to those Code provisions which expressly refer to the fair market value of property in determining the amount of gain or loss with respect to certain transfers of property, e.g., determinations under section 311 (relating to corporate distributions), section 338 (relating to stock purchases treated as asset acquisitions), section 751(c) (relating to transfers of partnership interests), and sections 617, 1245, 1250, 1252, 1254, and 1255 (relating to the treatment of certain gain from the disposition of property).[14] The provision is not intended to affect the tax treatment of dispositions (e.g., actual sales of property) in which the amount of gain or loss is computed by reference to the amount realized from the disposition (under section 1001) (rather than based on a determination of fair market value pursuant to a specific Code provision), whether or not the amount realized is determined in whole or in part by reference to liabilities to which a property is subject (see *Commissioner* v. *Tufts*, 461 U.S. 300 (1983)). Nor would the provision have any application to transactions covered by section 752(c).[15] The provision also is not intended to affect the determination of the basis of property in the hands of the transferee. (See *Estate of Franklin* v. *Commissioner*,

[14] As in the case of a disposition with respect to which gain is computed under section 1001, liabilities incurred by reason of the acquisition of the property which were not taken into account in determining the transferor's basis shall not be taken into account in determining the amount of gain or loss under this provision (see Treas. Reg. sec. 1.1001-2(a)(3))

[15] The Conference Report (p. 864) in stating this point contained a typographical error, so that section 751(c) was cited where section 752(c) was intended

544 F.2d 1045 (9th Cir. 1976)). No inference is intended as to whether or not the results obtained by applying the provision will differ from those obtained under prior law.

Effective Date

The provision applies to distributions, sales, and exchanges made after March 31, 1984, in taxable years ending after that date.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $50 million annually for the years 1986 through 1989.

6. Use of Tiered Partnerships to Alter Character of Income on Exchanges of Partnership Interest (sec. 76 of the Act and sec. 751 of the Code)[16]

Prior Law

Gain or loss on the sale or exchange of a partnership interest is generally capital gain or loss. However, money or property received by a transferor partner in exchange for all or part of his partnership interest is subject to ordinary income treatment to the extent it is attributable to certain ordinary income assets of the partnership (section 751). These items include (1) certain unrealized receivables of the partnership, and (2) inventory items of the partnership which have appreciated substantially in value. Generally, substantially appreciated inventory is defined as inventory having a fair market value greater than 120 percent of the partnership's adjusted basis for the property and greater than 10 percent of the fair market value of all partnership property, other than money. Unrealized receivables of a partnership include (1) rights to payments that have not yet been taken into account under the partnership's method of accounting and (2) a variety of recapture amounts with respect to partnership property. Ordinary income treatment also applies to distributions to a partner that have the effect of causing a shifting of the various partners' interests in unrealized receivables or substantially appreciated inventory of the partnership. The rules of section 751 prevent a partner from receiving capital gain treatment for gains attributable to ordinary income property of the partnership.

Under prior law, some taxpayers argued that ordinary income treatment of gains attributable to unrealized receivables and substantially appreciated inventory could be avoided when the assets are held in a second partnership. It was not clear under prior law whether the ordinary income rules of section 751 were to be applied to such cases by regarding a change in interests in the first partnership as an exchange of a capital asset (the interest in the second partnership) or of ordinary income assets (the assets owned through the second partnership).

Reasons for Change

Congress believed that taxpayers should not be allowed to convert potential ordinary income into capital gains by selling their partnership interests. This policy has been reflected in the 1954

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[16] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, section 76; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1228-1229; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, section 60; S. Rpt. 98-169, Vol. 1 (April 2, 1984), pp. 239-240; and H. Rep. No. 98-861 (June 23, 1984), p. 865 (Conference Report).

Code since its enactment. Congress believed that here, as elsewhere, the use of tiered partnership arrangements should not be permitted to frustrate the policy of the Code or to achieve a more attractive tax result than the use of a single partnership.

Explanation of Provision

Under the Act, in determining whether partnership property is an unrealized receivable or an inventory item under section 751, the partnership is to be treated as owning its proportionate share of the property of any other partnership in which it is a partner. Thus, the ordinary income rules of section 751 are applied by regarding income rights (as section 751 was intended to under prior law)[17] as severable from the partnership interest, and a partner is treated as disposing of such items independently of the rest of his partnership interest. This rule applies regardless of how many tiers of partnerships exist between the transferring or distributee partner and the ordinary income assets.

The Act also provides that similar rules are to apply to interests in trusts held by partnerships, in a manner to be provided in regulations.

Congress did not intend to create any inference regarding the tax treatment of any of these transactions under prior law.

Effective Date

The provision is effective for distributions, sales, and exchanges made after March 31, 1984, in taxable years ending after that date.

Revenue Effect

This provision is estimated to have a negligible effect on fiscal year budget receipts.

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[17] See H.R. Rep. No. 1337, 83rd Cong. 2nd Sess., pp. 70, 71 (March 9, 1954).

7. Exchanges of Like-Kind Property (sec. 77 of the Act and sec. 1031 of the Code)[18]

Prior Law

General rules

An exchange of property, like a sale, is generally a taxable transaction. However, under section 1031, no gain or loss is to be recognized if property held for productive use in the taxpayer's trade or business, or property held for investment purposes, is exchanged solely for property of a like-kind that is also to be held for productive use in a trade or business or for investment. Under both prior and present law, this provision specifically does not apply to exchanges of stock in trade or other property held primarily for sale, or to stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest.[19]

The nonrecognition of gain in a like-kind exchange applies only to the extent that like-kind property is received in the transaction. For example, if a taxpayer holding a parcel of land having a basis of $50,000 and a fair market value of $100,000 exchanges the property for a parcel of land worth $90,000 plus $10,000 in cash, the taxpayer would recognize $10,000 of gain on the transaction. The remaining $40,000 of gain would be deferred until the taxpayer disposes of the second parcel as a taxable sale or exchange. No losses may be recognized from a qualifying like-kind exchange.

Deferred like-kind exchanges

Prior law did not specifically require that a like-kind exchange be completed within a specified period in order to qualify for tax-free treatment. Additionally, there was no requirement that the property to be received be identified at or near the time of the transfer of property. In *Starker* v. *United States*, 602 F.2d 1341 (9th Cir. 1979), the United States Court of Appeals for the Ninth Circuit held that an exchange qualified for like-kind treatment even though the property to be exchanged could be designated by the transferor for up to 5 years after the transaction and even though, under the terms of the transaction, the transferor could have ultimately received cash rather than like-kind property. The case in-

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[18] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, section 77; H. Rep. No 98-432, Pt. 2 (March 5, 1984), pp. 1231-1234; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, section 61; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 241-244; H. Con. Res. 328, 130 Cong. Rec. S. 8943 (June 29, 1984), H. 7525 (June 29, 1984); and H. Rep. No. 98-861 (June 23, 1984), pp. 865-867 (Conference Report).

[19] Special rules allow tax-free like-kind exchanges of stock of the same corporation (sec. 1036), certain insurance policies (sec. 1035), and certain U.S. obligations (sec. 1037). Additionally, the law provides for nonrecognition of gain in certain situations in which property lost or sold by the taxpayer is replaced, within a specified period, by property of a similar kind.

volved an exchange of real property in which the transferor eventually received like-kind property.

Installment sale rules.—The Internal Revenue Code provides special rules for the reporting of income from installment sales (sec. 453). An installment sale is defined as a disposition of property in which at least one payment is received after the close of the taxable year in which the disposition occurs. For this purpose (but not for purposes of determining the amount of gain on the sale), payment includes property permitted to be received without the recognition of gain under section 1031 (sec. 453(f)(6)).

The installment sale rules allow gains from an installment sale to be spread out over the period during which installment payments are received. In general, the taxpayer reports income in each year for that proportion of the payments received during the year which is equivalent to the ratio which the gross profit from the sale bears to the total contract price.

Exchanges of partnership interests

Prior law did not state specifically whether an interest in one partnership could be exchanged for an interest in another partnership as a tax-free exchange of like-kind property. The Internal Revenue Service had ruled that the exception for equity interests in financial enterprises applied to partnership interests and that they did not qualify as like-kind property under section 1031 (Rev. Rul. 78-135, 1978-1 C.B. 256). Court decisions had held that exchanges of partnership interest may qualify for tax-free treatment as like-kind property exchanges where the underlying assets of the partnerships are substantially similar in nature. *Estate of Meyer* v. *Commissioner*, 58 T.C. 311 (1972), *aff'd per curiam*, 503 F.2d 556 (9th Cir. 1974); *Gulfstream Land and Development Co.* v. *Commissioner*, 71 T.C. 587 (1979). However, the court in *Estate of Meyer* held that an exchange of a general partnership interest for a limited partnership interest did not satisfy the like-kind exchange requirement.

Reasons for Change

Deferred like-kind exchanges

Congress was concerned that like-kind treatment of non-simultaneous exchanges had given rise to unintended results as well as administrative problems. These concerns extended to the underlying policy of the like-kind exchange rule.

The special treatment of like-kind exchanges has been justified on the grounds that a taxpayer making a like-kind exchange has received property similar to the property relinquished and therefore has not effectively "realized" a profit on the transaction. This rationale is less applicable in the case of deferred exchanges. To the extent that the taxpayer is able to defer completion of the transaction—often retaining the right to designate the property to be received at some future point—the transaction begins to resemble less a like-kind exchange and more a sale of one property followed, at some future point, by a purchase of a second property or properties. This is particularly true when (as was the case in the *Starker* v. *United States*) the taxpayer might have received like-kind or non-like-kind property in the future. Congress believed that like-kind exchange treatment is inappropriate in such situations and that the general rule requiring recognition of gain on sales or exchanges of property should apply to these cases.

The special treatment of like-kind exchanges has also been justified from an administrative standpoint because of the difficulty of valuing property which is exchanged solely or primarily for similar property. This rationale also is less applicable to deferred like-kind exchanges, in particular exchanges which are "left open" until the taxpayer has selected a suitable exchange property. In such cases, the transferred property must be valued at a specific or near-specific dollar amount in order to determine the aggregate value of the properties that the taxpayer may receive in the future. Thus, the taxpayer's gain may be measured with reasonable accuracy in the year of the original transfer.

Finally, Congress was concerned that the like-kind exchange rules, absent time limitations, significantly expanded the ability of taxpayers to avoid recognition of gain on deferred payment sales. Unlike other nonrecognition rules (e.g., the rollover of gain on replacement of a principal residence), the like-kind exchange provisions under prior law had no express statutory time limit on the availability of nonrecognition treatment. Decisions such as that in *Starker* v. *United States* suggest that there may, in fact, have been no limit on the time for which like-kind exchanges may be kept open. If this was the case, taxpayers, by combining the installment sale rules and the like-kind exchange provisions, could defer taxation on dispositions of property for an indefinite period of time, even if a right to receive cash instead of property was retained. If cash was ultimately received, the installment sale rules could achieve a deferral until the time of receipt, while if like-kind property was received, recognition could be even further delayed. By exercising the right to designate property shortly before death, a taxpayer could conceivably avoid any taxation on the sale at all. Interaction of the installment sale and like-kind exchange rules also raised serious administrative problems regarding the allocation of liabilities and basis among different properties, problems which may not be resolvable until all exchanges and payments required by the agreement have been completed; thus, the tax consequences of deferred exchanges may not be determined for many years after a transaction was initiated.

Exchanges of partnership interests

Whether the like-kind exchange provisions were originally intended to apply to exchanges of partnership interests is questionable. The statute, by its own terms, did not apply to exchanges of stock, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest under prior law. These exclusions prevented taxpayers from trading investment interests so as to take advantage of like-kind treatment on dispositions of appreciated property. Congress believed that, at least under current conditions, partnership interests typically represent investment interests similar to those items previously excluded from like-kind treatment and should therefore also be excluded from such treatment.

In reaching the decision above, Congress was particularly concerned by the use of the like-kind exchange rules to facilitate the exchange of interests in tax shelter investments for interests in other partnerships. Under this arrangement, taxation of the gain inherent in an interest in a "burned out" tax shelter partnership—i.e., a partnership which has taken substantial deductions for nonrecourse liabilities without actually paying off such liabilities, and hence without the partners suffering real economic loss—could be able to be avoided if the interest was exchanged, tax-free, for an interest in another partnership (provided the old partnership had an election to adjust basis in effect under section 754 and the new partnership did not). Although court decisions had limited like-kind exchange treatment to partnerships holding similar underlying assets, this rule may have been inadequate to deal with abuses involving burned-out tax shelters (which may nonetheless hold assets similar to other partnerships) and related administrative hardships. Congress believed that such abuses and hardships are best prevented by specifically excluding partnership interests from the like-kind exchange rule.

Explanation of Provisions

Deferred like-kind exchanges

The Act provides that, for purposes of the like-kind exchange provision, any property received by the taxpayer more than 180 days after the date on which the taxpayer relinquishes property (but in any case not later than the due date (with extensions) of the taxpayer's tax return) is not to be treated as like-kind property. Thus, tax-free treatment will be unavailable for exchanges not completed within this time period. In addition, property which was not identified as the property to be received by the taxpayer on the date the transferred property was relinquished or within 45 days after that date will not qualify as like-kind property. This requirement may be met by designating the property to be received in the contract between the parties.

The designation requirement may be satisfied if the contract between the parties specifies a limited number of properties that may be transfered and the particular property to be transferred is to be determined by contingencies beyond the control of both parties. For example, if A transferred real estate in exchange for a promise by B to transfer property 1 to A if zoning changes are approved and property 2 if they are not, the exchange would qualify for like-kind treatment. As under prior law, these rules do not permit a taxpayer who receives cash and later purchases the designated property to claim like-kind exchange treatment.

Exchanges of partnership interests

The Act provides that the like-kind exchange rules do not apply to any exchange of interests in different partnerships. The denial of like-kind treatment is not intended to apply to an exchange of interests in the same partnership. Further, the rule is not intended to apply to organizations which have elected, under section 761(a) of the Code, not to be subject to the provisions of Subchapter K of the Code; instead, an exchange of interests in such organizations would be treated as an exchange of interests in the assets of the respective organizations and the applicability of section 1031 would be determined on the basis of those exchanges.[20]

No inference should be drawn from Congress's action regarding the proper treatment of these transactions under present law.

Effective Date

Generally, the provision relating to deferred like-kind exchanges was effective for transfers after July 18, 1984, in taxable years ending after that date. Additionally, for transfers on or before July 18, 1984, any property received after December 31, 1986, will not be treated as like-kind property, unless the property to be received was designated in a written binding contract in effect on June 13, 1984 and at all times thereafter before the exchange is completed, in which case like-kind property may be received until December 31, 1988. In the case of any transfer which the taxpayer originally treated as part of a like-kind exchange and which is subject to tax as a result of the provision, the period for assessing any deficiency of tax does not expire prior to January 1, 1988 (if the period for receiving like-kind property is extended to December 31, 1988, this period does not expire prior to January 1, 1990).

Generally, the provision relating to exchanges of partnership interest was effective for transfers of property after July 18, 1984, in taxable years ending after that date. An exception is provided for exchanges made pursuant to binding contracts in effect on March 1, 1984, and at all times thereafter before the exchange is completed. The denial of like-kind exchange treatment also does not apply to exchanges of general partnership interests pursuant to a plan of reorganization of ownership interests which took effect on March 29, 1984, provided that all of the exchanges contemplated by the reorganization plan are completed by the end of calendar year 1984.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $82 million in 1985, $362 million in 1986, $667 million in 1987, $788 million in 1988, and $842 million in 1989.

[20] See 130 Cong. Rec. H. 7113 (June 27, 1984) (statement of Mr. Rostenkowski), S. 8410 (June 27, 1984) (statement of Sen. Dole).

8. Use of Tiered Partnership to Achieve Step-Up in Basis of Partnership Assets (sec. 78 of the Act and sec. 734 of the Code)[21]

Prior Law

The partnership provisions of the Code were generally designed to permit partners to enter and leave a partnership without recognizing gain or loss. To prevent the general rules from allowing a partner to escape tax on gain altogether, or from extinguishing a loss that the partner would otherwise be entitled to, the Code provided for a variety of rules relating to the basis of the partners' interests in the partnership and in contributed or distributed property, and to the partnership's basis in partnership property.

In certain transactions, a partner may experience an increase or decrease in basis under the general rules that is not reflected appropriately in the basis of other assets. For example, if a partnership distributes property which it holds at a basis of $900 to a partner with an interest having a $500 basis, the Code does not permit the $900 basis to carry over with the property but instead requires a substitution of the $500 basis. Thus, $400 of basis is potentially "lost."

To avoid this result, prior and present law permit, but do not require, a partnership in such a case to elect to adjust the basis of remaining partnership assets. A similar result applies in the case of transfers of interests in the partnership (section 743). The election to step up (or step down) may be revoked only upon a showing of sufficient reason and applies to all distributions by a partnership and to all transfers of interests in the partnership. (Since the election may at some future date require a decrease in basis, partnerships may decide not make the election even if it appears at first to be advantageous.)

Under prior law, it may have been possible in a tiered partnership arrangement to manipulate the basis adjustment rules and the election to adjust basis in such a manner as to effectively distribute high basis property to a low basis partner without causing him to recognize gain when the property is sold. For example, assume that partnership AB held two assets, asset 1 with a basis of 0 and a fair market value of $100 and asset 2 with a basis of $100 and a fair market value of $100. A distribution of asset 2 to partner A, who had a zero basis for his interest, would have resulted in A holding the asset at a zero basis, and the basis of asset 1 being increased to $100, assuming that the partnership had a section 754 election in effect. Thus, if asset 1 were sold, no gain or loss would

[21] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, section 78; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1229-1230; and H. Rep. No. 98-861 (June 23, 1984), pp. 867-868 (Conference Report).

have been realized by the partnership, but if asset 2 were sold, A would have realized $100 gain. However, if instead of being distributed, asset 2 was contributed to a second partnership in which partnership AB has a major interest (e.g., 99 percent), its basis would have remained at $100. A distribution of AB's interest in the second partnership to partner A would have resulted in the basis of that interest being reduced to zero but (if the second partnership did not have a section 754 election in effect) the basis of asset 2 would have remained $100, while the basis of asset 1 (as in the prior example) would have increased to $100. Thus, the effect would have been an increase in total basis of assets so that, in this example, both asset 1 and asset 2 could subsequently be sold without recognition of gain. (While the basis of A's interest in the second partnership would have been reduced by $100, this would not have had any effect so long as A retained his interest in the partnership.) A could also cause asset 1 to be sold and reinvest the proceeds through the second partnership without recognizing any gain. Taxpayers could also attempt to create more complex arrangements to achieve results similar to the results described above under prior law.

Reasons for Change

Congress believed that it was inappropriate for taxpayers to defer or avoid taxation by using inconsistent basis adjustment elections for related partnerships.

Explanation of Provision

The Act prohibits a partnership from increasing the basis of partnership property following a distribution of an interest in a second partnership if the second partnership does not have a section 754 election in effect. This provision is intended to prevent taxpayers from achieving a net step-up in the basis of assets by means of inconsistent elections under section 754.[22]

Effective Date

This provision was effective for distributions after March 1, 1983, in taxable years ending after that date.

Revenue Effect

This provision is estimated to have a negligible effect on fiscal year budget receipts.

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[22] This occurs because under section 743 a distribution of a partnership interest is treated as a distribution of the underlying assets (see item 5., above).

9. Allocation of Certain Liabilities to Limited Partners (sec. 79 of the bill and sec. 751 of the Code.)[23]

Prior law

In general.—A partner is entitled to deduct his allocable share of partnership losses to the extent of the adjusted basis of his partnership interest. A partner's basis in his interest is, in turn, increased to the extent of his proportionate share of partnership liabilities.

When a partner personally assumes liability for partnership debts, the basis of his interest is increased to the extent of the liabilities assumed. When none of the partners is personally liable for a partnership debt (nonrecourse liabilities), Treasury regulations provide that all of the partners, including limited partners, may increase the basis of their interests by their share of the debt, which is determined in accordance with the interest in partnership profits (Treas. Reg. sec. 1.752-1(e)).

In *Raphan* v. *United States*, 3 Cl. Ct. 457 (1983), the United States Claims Court held that a general partner was not to be treated as personally liable with respect to an otherwise nonrecourse debt because he guaranteed repayment of the debt. Thus, the debt remained a nonrecourse liability and the limited partners were entitled to include a portion of the debt in computing the basis of their partnership interests (thereby increasing the maximum amount of partnership deductions which could be allocated to the limited partners). The Internal Revenue Service had taken a contrary position in a published ruling (Rev. Rul. 83-151, 1983-2 C.B. 105).

At-risk rules.—The at-risk rules prevent taxpayers from deducting losses in excess of amounts which the taxpayer actually risks losing as a result of an investment. Because limited partners are not personally liable for partnership liabilities, the at-risk rules, where applicable, generally prevent limited partners from deducting losses in excess of amounts invested in the partnership. The at-risk rules are not applicable to real estate investments.

Reasons for Change

Congress believed the holding in *Raphan* v. *United States* resulted in an inappropriate increase in the limited partners' basis in their interests. Congress also believed that the rules for sharing partnership liabilities under Treasury regulation section 1.752-1(b) are outdated and required revision to ensure that the partner receiving the basis with respect to a partnership liability bears (to

[23] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, section 79; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1235-1236; and H. Rep. No. 98-861 (June 23, 1984), pp. 868-869 (Conference Report).

the extent possible) the economic risk of loss with respect to such liabilities. Similarly, Congress was concerned with the lack of definition of when an "assumption" of a partnership liability takes place under section 752.

Explanation of Provision

The Act provides specifically that the Claims Court decision in *Raphan* v. *United States* is not to be followed for purposes of applying section 752 or the regulations thereunder. In addition, the Treasury is to revise and update its regulations under section 752, as soon as practicable, to reflect the overruling of the *Raphan* decision and to take account of current commercial practices and arrangements relating to partnership liabilities, including regulations concerning the treatment of guarantees, assumptions, indemnity agreements, and other similar arrangements. These regulations are to specify that indebtedness (or a portion thereof) for which a general partner is primarily or secondarily liable (whether in his capacity as a partner or otherwise) is not nonrecourse liability providing additional basis for limited partners' interests in a partnership. (When a limited partner guarantees a liability, the regulations will not shift the basis attributable to that liability away from the limited partner as a result of the guarantee.)

It was intended that the new regulations reject the holding of the *Raphan* decision effective March 1, 1984 (i.e., for losses accrued on or after that date), and that other changes in the regulations apply prospectively from the date new regulations are proposed or some later date specified by the Treasury. Congress did not intend that any inference should be drawn regarding the validity of the *Raphan* decision for transactions prior to March 1, 1984, and did not intend to affect in any way the rights of the various parties to that case.

It was intended that the revisions to the section 752 regulations be based largely on the manner in which the partners, and persons related to the partners, share the economic risk of loss with respect to partnership debt (other than bona fide, third party nonrecourse debt, as defined by such regulations). For example, the basis attributable to a nonrecourse loan made to the partnership by a partner would be treated in the same manner as basis attributable to a bone fide third party nonrecourse loan which that partner guaranteed. With respect to bona fide, third party nonrecourse debt, Congress did not expect that the regulations will make major changes to the manner in which the partners' shares are determined, but the regulations may attempt to provide more certainty than presently exists.

Effective Date

The overruling of the Claims Court decision in *Raphan* v. *United States* was effective on March 1, 1984. The direction to the Treasury Department to revise its regulations under section 752 was effective on July 18, 1984; however, it was anticipated that these regulations (except to the extent that they overrule the *Raphan* decision) will apply on a prospective basis only.

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Revenue Effect

The effects of this provision are included in the estimated revenues for other partnership provisions.

F. Trust Provisions

1. Trust Distributions (sec. 81 of the Act and sec. 643 of the Code)[1]

Prior Law

Under prior law, beneficiaries were taxed on amounts distributed from a trust or estate to the extent of the trust's or estate's distributable net income. The trust or estate was allowed a deduction for amounts taxed to its beneficiaries. Prior Treasury Department regulations provided that distributions of property were deemed to carry out distributable net income to the extent of the property's value at the time of distribution. In such a case, no gain or loss was realized on the distribution by the trust or estate,[2] and the basis of the property in the hands of the beneficiary was its value to the extent it carried out distributable net income. Treas. Reg. sec. 1.661(a)-2(f).

Reasons for Change

Where a trust or estate had distributable net income and distributed property, the effect of the prior Treasury Department regulations was to exempt the gain or loss entirely from tax. Congress believed that the gain or loss should be taxed to either the beneficiary or the trust (or estate).

Explanation of Provision

The Act provides that distributions of property from a trust or estate are treated as carrying out distributable net income only to the extent of the lesser of the property's basis or its fair market value at the time of distribution. Under this rule, the basis of the property in the hands of the beneficiary will be the same as the trust's or estate's basis in the property. Alternatively, the Act permits the trustee or executor to elect to treat distributions of property as taxable events resulting in recognition of gain or loss on the distribution as if the property had been sold to the beneficiary.

The Act does not change prior law in those cases where a distribution of property to a beneficiary results in the recognition of gain or loss to the trust or estate (e.g., the rule providing a basis adjustment for property received in satisfaction of a pecuniary be-

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[1] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 81; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), p. 1237; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 81; S. Prt. 98-169, Vol. I (April 2, 1984), p. 245; and H. Rep. No. 98-861 (June 23, 1984), p. 869 (Conference Report).

[2] Under Rev. Rul. 67-74, 1974-1 C.B. 194, the distribution of property to a beneficiary in satisfaction of the right to receive income currently resulted in the recognition of gain or loss to the trust.

quest continues to apply).[3] Additionally, Congress did not intend that this provision change the prior-law tax effects of charitable contributions. For example, if a trust beneficiary makes a gift to a charitable organization of property received in an in-kind distribution from a trust or estate, that transfer is not to be considered a taxable disposition within the meaning of the Code. The prior-law rules governing gifts of appreciated property to charitable organizations (as modified by the Act) also will continue to apply to such gifts.

Effective Date

The provision is effective with respect to distributions made after June 1, 1984, in taxable years ending after that date.

A special transition rule provides that the time for making the election to treat distributions of property that occurred before July 18, 1984, as taxable events will not expire before January 1, 1985.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by less than $10 million in 1984, $64 million in 1985, $261 million in 1986, and $409 million in 1987, $438 million in 1988, and $467 million in 1989.

[3] In the case of a distribution by a trust of property whose value is less than its basis, section 267 would deny a loss deduction to the trust. However, section 267 does not apply to deny a deduction to an estate in such a case.

2. Taxation of Multiple Trusts (sec. 82 of the Act and sec. 643 of the Code)[4]

Prior Law

Trusts are treated as separate taxable entities with respect to certain accumulated and undistributed income (Code sec. 641). Trusts are taxed under a separate progressive rate schedule (sec. 1(e)).

Treasury Department regulations adopted following the Tax Reform Act of 1969 provided that multiple trusts were treated as one trust if the trusts had (1) the same grantor and substantially the same beneficiary, (2) no substantially independent purposes (such as independent dispositive purposes), and (3) as their principal purpose the avoidance or mitigation of progressive rates of tax (including mitigation as a result of deferral of tax) or avoidance or mitigation of the alternative minimum tax.[5]

In *Edward L. Stephenson Trust* v. *Commissioner*, 81 T.C. 283, the Tax Court held that the Treasury Department regulations regarding multiple trusts were invalid because the Internal Revenue Code did not support a subjective test of tax avoidance motive as a basis for determining the existence of multiple trusts. The court further held that Congress, by enacting a series of more limited rules relating to multiple trusts in the Tax Reform Acts of 1969 and 1976, had implicitly accepted an earlier Tax Court decision which held that the motive for establishing and maintaining multiple trusts was irrelevant for tax purposes.[6]

Reasons for Change

Because of the progressive tax structure, it would be possible to reduce income taxes significantly by establishing multiple trusts having the same grantor and the same or similar beneficiaries unless there were rules providing for aggregation of trusts in certain cases. For example, if, instead of establishing one $1 million trust, a taxpayer established ten essentially identical $100,000 trusts, the taxpayer would be able to secure a significantly lower marginal tax rate for the undistributed income of the trusts.

Congress was concerned that, without the restrictions of the Treasury Department regulations, persons would be able to reduce significantly the taxation of investment income through the cre-

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[4] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 82; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), p. 1239; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 81; S. Prt. 98-169, Vol. I (April 2, 1984), p. 245; H. Rep. No. 98-861 (June 23, 1984), p. 870 (Conference Report).

[5] Treas. Reg. sec. 1.641(a)-0(c).

[6] *Estelle Morris Trusts* v. *Commissioner*, 51 T.C. 20 (1968), *aff'd per curiam* 427 F.2d 1361 (9th Cir. 1970).

ation of multiple trusts. Accordingly, Congress believed that rules similar to the rules contained in the prior Treasury regulations should be legislated.

Explanation of Provision

The Act provides that, under Treasury regulations, two or more trusts will be treated as one trust if (1) the trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and (2) a principal purpose for the existence of the trusts is the avoidance of Federal income tax. The Act provides the Treasury Department with broad regulatory authority to implement the purposes of this provision, including authority to adopt rules or exceptions in situations involving both domestic and foreign trusts. For example, in the case of a U.S. grantor, Congress did not intend application of this rule to a foreign trust whose income is taxable to a U.S. grantor (sec. 679).

For purposes of these rules, a husband and wife are treated as one beneficiary or grantor. Also, trusts will not be treated as having different primary beneficiaries merely because the trusts have different contingent beneficiaries. Similarly, trusts will not be treated as having different grantors by having different persons making nominal transfers to the trusts.

For example, Congress expects that the Treasury regulations will treat the trusts in the following example as one trust:

> A establishes, with the principal purpose of avoidance of Federal income tax, Trust 1 for the benefit of his sister S1, his brother B1, and his brother B2; Trust 2 for the benefit of his sister S2, his brother B1, and his brother B2; Trust 3 for the benefit of his sister S1, his sister S2, and his brother B1; and Trust 4 for the benefit of his sister S1, his sister S2, and his brother B2. Under each trust instrument, the trustee is given discretion to pay any current or accumulated income to any one or more of the beneficiaries.

Where there are substantial independent purposes, and tax avoidance is not a principal purpose for the existence of separate trusts, the trusts will not be aggregated. The following is an example of where separate trusts will not be aggregated under the Act:

> X establishes two irrevocable trusts for the benefit of X's son and daughter. Son is the income beneficiary of the first trust and the trustee (Bank of (P) is required to pay all income currently to son for life. Daughter is the remainder beneficiary. X's daughter is an income beneficiary of the second trust and the trust instrument permits the trustee (Bank of D) to accumulate or to pay income, in its discretion, to daughter for her education, support, and maintenance.The trustee also may pay income or corpus to son for his medical expenses. Daughter is the remainder beneficiary and will receive the trust corpus upon son's death.

Effective Date

This provision is effective for taxable years beginning after March 1, 1984.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $50 million in 1984, $173 million in 1985, $129 million in 1986, $27 million in 1987, $26 million in 1988, and $21 million in 1989.

G. Accounting Changes

1. Premature Accruals (sec. 91 of the Act and new sec. 461(h) of the Code)[1]

Prior Law

General

Prior law provided that, under the accrual method of accounting, an expense was deductible for the taxable year in which all the events had occurred which determined the fact of the liability and the amount thereof could be determined with reasonable accuracy (the so-called "all events test") (Treas. Reg. sec. 1.461-1 (a)(2)). If the "all events" test was satisfied, an accrual basis taxpayer generally could deduct the full face amount of the liability (ignoring any discounting of the amount to reflect the time value of money).

Fact of liability

In a number of early cases, the courts held that expenditures are deductible only when the activities that the taxpayer is obligated to perform are in fact performed, not when the "fact" of the obligation to perform is determined. For example, in *Spencer, White & Prentis, Inc.* v. *Commissioner*, 144 F.2d 45 (2d Cir. 1944), a contractor, who was engaged in the construction of a subway system and who was required under contract to restore certain property damaged or otherwise affected by the construction, was denied deductions for the accrued estimated costs of restoration. The court held that the liability for work done after the end of the taxable year had not been incurred because the work had not been performed. The court also held that deductions were only allowable when the taxpayer's liability to pay became definite and certain.

More recently, the courts generally have reached a different conclusion: a taxpayer may deduct the amount of a liability if all the events that fix the liability have occurred and the amount can be determined with reasonable accuracy, even though the activities the taxpayer is obligated to perform are not actually performed until a later year. For example, the Fourth Circuit held that surface mining reclamation costs that could be estimated with reasonable accuracy were properly accrued when the land was stripped although the land was not reclaimed until a subsequent year. *Harrold* v. *Commissioner*, 192 F.2d 1002 (4th Cir. 1951).

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[1] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 91; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1252-1257; "Deficit Reduction Act of 1984," as approved by The Senate Committee on Finance on March 21, 1984, sec. 71; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 264-269; H. Rep. No. 98-861 (June 23, 1984), pp. 871-877 (Conference Report); and H. Con. Res. 328, 130 Cong. Rec. S. 8943 (June 29, 1984), H. 7525 (June 29, 1984).

The position of the Fourth Circuit with respect to strip mining reclamation costs has been extended by other courts to certain other situations. For example, the Ninth Circuit held that the fact of the liability under workers' compensation laws[2] is determined in uncontested cases in the year in which injury occurs, even though medical services may be rendered at a future time. *Crescent Wharf & Warehouse Co.* v. *Commissioner*, 518 F.2d 772 (9th Cir. 1975).

A deduction for a contingent liability generally is not allowed under present or prior law, because all of the events necessary to fix the liability have not yet occurred. However, in one recent case, the Third Circuit held that a taxpayer was allowed to deduct amounts paid to a trust to fund benefits under a negotiated supplemental unemployment benefit plan, including amounts accrued in a "contingent liability account" (at a fixed rate for each hour worked by eligible employees until a target funding amount is reached). *Lukens Steel Co.* v. *Commissioner*, 442 F.2d 1131 (3d Cir. 1971). The fact that the liability was to a group, rather than a specific individual, and that the time of future payment was indefinite, did not bar, in the Court's view, a deduction under the all events test.

The courts generally have held that the length of time between accrual and performance does not affect whether an amount is properly accruable. However, in *Mooney Aircraft, Inc.* v. *United States*, 420 F.2d 400 (5th Cir. 1969), the court held that a taxpayer, who gave to purchasers of its airplanes a bond redeemable when the plane was permanently retired from service, was not allowed a deduction because the possible interval between accrual and payment was "too long"; the court concluded that the likelihood of payment decreases as the time between accrual and payment increases.

The Internal Revenue Service takes the position that, for an amount to be deductible, there must be a current liability to pay that amount, and there must not be a contingency as to payment (other than the ability of the obligor to pay). Rev. Rul. 72-34, 1972-1 C.B. 132.

Amount of liability

In order for an amount to be deductible under the all events test, the amount of a liability must be determinable with reasonable accuracy. The courts have held that this rule is satisfied if the amount of the liability, although not definitely ascertained, can be estimated with reasonable accuracy. Generally, estimates based on industry-wide experience or the experience of the taxpayer have been accepted by the courts as reasonable. In a recent case, the Ninth Circuit permitted the question of the reasonable accuracy of the amount reserved for anticipated liabilities to be determined by estimating the amount of the liability on an aggregate rather than on an individual claim basis, as had generally been required in earlier cases. *Kaiser Steel Corp.* v. *United States*, 411 F.2d 235 (9th Cir. 1983).

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[2] Under workers' compensation laws, employers generally are required to pay injured employees' medical expenses and disability benefits. In many cases, the employer's payments of the benefits extends over several years.

The Internal Revenue Service generally takes a more restrictive position. Under their view, the exact amount of a liability must be determinable by a computation based on presently known or knowable factors. For example, the Service held that the taxpayer who was in the business of strip mining did not know, nor was it possible to know, the amount of an expenditure since the reclamation work was not rendered by the taxpayer nor did the taxpayer contract with a third party to perform the services (I.R.S. Letter Ruling 7831003).

Reserve accounts

The Internal Revenue Code of 1954, as originally enacted, contained a provision allowing accrual method taxpayers to establish reserves for estimated business expenses and to deduct reasonable additions to the reserve (Code sec. 462). Congress retroactively repealed the provision in 1955 primarily for revenue reasons and because of potential abuses (Pub. L. 84-74, 69 Stat. 134 (1955)).

Net operating losses

Net operating losses incurred in a taxable year generally may be "carried back" and offset against taxable income of the 3 years preceding the year of loss and, if not fully absorbed, "carried forward" and offset against taxable income of the 15 years succeeding the year of loss. A special 10-year carryback is permitted for product liability losses and in certain other cases.

Reasons for Change

Congress believed that the rules relating to the time for accrual of a deduction by a taxpayer using the accrual method of accounting should be changed to take into account the time value of money and the time the deduction is economically incurred. Recent court decisions in some cases permitted accrual method taxpayers to deduct currently expenses that were not yet economically incurred (i.e., that were attributable to activities to be performed or amounts to be paid in the future). Allowing a taxpayer to take deductions currently for an amount to be paid in the future overstates the true cost of the expense to the extent that the time value of money is not taken into account; the deduction is overstated by the amount by which the face value exceeds the present value of the expense. The longer the period of time involved, the greater is the overstatement.

Congress was concerned about the potential revenue loss from such overstated deductions. In many everyday business transactions, taxpayers incur liabilities to pay expenses in the future. Congress believed that because of the large number of transactions in which deductions may be overstated and because of the high interest rates in recent years, the magnitude of the revenue loss could be significant.

Finally, the failure of prior law to take into account the time value of money had become the cornerstone for a variety of tax shelters. For example, a tax shelter partnership could obligate itself to pay someone to perform research and development in the future and claim a current deduction for the undiscounted amount of the future payments.

Congress recognized that, in the case of noncapital items, a taxpayer, theoretically, should be allowed a deduction for either the full amount of a liability when the liability is satisfied or a discounted amount at an earlier time. However, Congress also recognized that determining the discounted values for all kinds of future expenses would be extraordinarily complex and would be extremely difficult to administer. For instance, a system that allowed current deductions for discounted future expenses would have to include a complex set of rules for recalculating overstated and understated deductions when the future liabilities are reestimated or are actually satisfied at a time, or in an amount, different from that originally projected. Furthermore, in the case of future expenditures, an appropriate discounting system may be equally complex. Therefore, in order to prevent deductions for future expenses in excess of their true cost, while avoiding the complexity of a system of discounted valuation, Congress believed that expenses should be accrued only when economic performance occurs.

Congress recognized that in many ordinary business transactions, economic performance may not occur until the year following the year in which the deduction may be taken under the all events test. Therefore, to avoid disrupting normal business and accounting practices and imposing undue burdens on taxpayers, Congress believed that an exception to the economic performance requirement should be provided for certain recurring items.

Explanation of Provision

In general

The Act provides that, in determining whether an amount has been incurred with respect to any item during the taxable year by a taxpayer using the accrual method of accounting, all the events which establish liability for such amount generally are not to be treated as having occurred any earlier than the time economic performance occurs. The all events test is met if all events have occurred which determine the fact of liability and the amount of such liability can be determined with reasonable accuracy. If economic performance has occurred and the other requirements of the all events test are met, the amount is treated as incurred for all purposes of the Code. If amounts incurred are chargeable to a capital account or, under any other provision of the Code, are deductible in a taxable year later than the year when economic performance occurs then such other provisions apply in determining the amount deductible each year.

The Act provides special rules relating to nuclear power plant decommissioning costs and to costs associated with reclamation and closing of mine and solid waste disposal sites (see items 2 and 3, *infra*).

Economic performance

The Act provides a series of principles for determining when economic performance occurs. The principles provided by the Act describe the two most common categories of liabilities: first, cases where the liability arises as a result of another person providing goods and services to the taxpayer and, second, cases where the liability requires the taxpayer to provide goods and services to another person or undertake some activity as a result of its income-producing activities.

With respect to the first category of liabilities, if the liability arises out of the use of property, economic performance occurs as the taxpayer uses the property. If the liability requires a payment for the providing of property, economic performance occurs when the property is provided. However, Congress intended that the Treasury Department issue regulations providing that the time at which property is provided should include the time of delivery, shipment, or other time so long as the taxpayer accounts for such items consistently from year to year. If the liability of the taxpayer requires a payment to another person for the providing of services to the taxpayer by another person, economic performance generally occurs when such other person provides the services.

With respect to the second category of liabilities, if the liability of the taxpayer requires the taxpayer to provide property or perform services, economic performance occurs as the taxpayer provides the property or performs the services. For this purpose, property does not include money; that is, economic performance generally does not occur as payments are made except as specifically provided in the Code or regulations. For example, if a contractor is engaged by a highway construction company to repair damaged properties, economic performance occurs as the contractor performs the work. Likewise, when the highway construction company itself repairs the damage, economic performance occurs as repairs are made.

Under a special rule for workers' compensation and tort liabilities requiring payments to another person, economic performance occurs as payments are made to that person. In the case of any other liability of the taxpayer, economic performance will occur at the time determined under regulations to be prescribed by the Treasury.

Exception from economic performance requirement for certain recurring items

In general

The Act provides an exception under which certain expenses may be treated as incurred in the taxable year in which the all events test is otherwise met even though economic performance has not yet occurred. This exception applies if four conditions are met: (1) the all events test, without regard to economic performance, is satisfied with respect to the item during the taxable year; (2) economic performance occurs within a reasonable period (but in no event more than 8-1/2 months) after the close of the taxable year; (3) the item is recurring in nature and the taxpayer consistently from year to year treats items of that type as incurred in the taxable year in which the all events test is met; and (4) either (a) the item is not material, or (b) the accrual of the item in the year in which the all events test is met results in a better matching of the item with the income to which it relates than would result from accruing the item in the year in which economic performance occurs.

This exception does not apply to workers' compensation or tort liabilities.

Recurrency and consistency

In determining whether an item is recurring in nature and is consistently reported by the taxpayer, consideration should be given to the frequency with which the item and similar items are incurred (or expected to be incurred) and the manner in which these items have been reported for Federal income tax purposes. Congress intended this exception to be available to taxpayers starting up a trade or business as well as to taxpayers already in a trade or business. In addition, a new type of expense or an expense that does not recur every year should not necessarily be excluded from this exception.

Materiality

The factors taken into account in determining the materiality of an item will include the size of the item, both in absolute terms and in relation to the taxpayer's income and other expenses, and the treatment of the item on the taxpayer's financial statements. If an item is considered material for financial statement purposes, it will also be considered material for tax purposes.

For example, assume that a calendar-year taxpayer enters into a one-year maintenance contract on July 1, 1985. If the amount of the expense is prorated between 1985 and 1986 for financial statement purposes, it should also be prorated for tax purposes. If, however, the full amount is deducted in 1985 for financial statement purposes because it is not material under generally accepted accounting principles, it may (or may not) be considered an immaterial item for purposes of this exception.

In some circumstances, items that are not material for financial accounting purposes may be treated as material items under this provision. For example, an item of expense which is immaterial for purposes of consolidated financial statements that combine a corporate taxpayer's financial data with those of affiliated companies may be material if the taxpayer is viewed separately. Also, an item of expense, which is immaterial for purposes of the financial statements but which is significant in terms of absolute dollar size, may be treated as material under this provision.

Congress intended that where the item is directly related to an activity, the materiality of the item will be separately determined with respect to that activity. The materiality of overhead expenses that relate to several activities of the taxpayer will be measured against those collective activities.

In the case of any partnership or other pass-through entity, Congress intended that, to the extent provided in regulations, an item will be considered immaterial only if it is not material when analyzed at both the entity level and at the partner level (or, in the case of a trust or estate, beneficiary level). Thus, an item that is immaterial at the partnership level may be material at the partner level. This rule may be applied, for example, when a partner invests in an accrual method partnership that makes a special allocation to the partner of an item that is not material to the partnership but is material to the partner. Congress intended this rule to be applied in such a manner that no significant additional reporting requirements be imposed on partnerships and other flow-through entities with respect to transactions where the likelihood is minimal that a partner's (or beneficiary's) deductions may be overstated.

Finally, Congress intended that the above standards for determining whether an item is a material item apply only for purposes of the recurring item exception to the economic performance test. No inference is implied with respect to whether an item is material for purposes of any other Code provision. For example, an item that may not be considered material for purposes of the economic performance test may nevertheless be material for purposes of the fraud and false statement provisions of the Code (sec. 7206(1)). Likewise, an item that is not material under the economic performance exception may be material under the provisions relating to changes in methods of accounting (see Treas. reg. sec. 1.446-1(e)(2)(ii)(a)).

Matching

In determining whether the accrual of a material item in a particular year results in a better matching of the item with the income to which it relates, generally accepted accounting principles will be an important factor, although not necessarily dispositive. Costs directly associated with the revenue of a period are properly allocable to that period.[3] For example, a sales commission agreement may require certain collection activities to be performed in a year subsequent to the year in which sales income is reported. In such a case, economic performance with respect to some portion of the liability to pay the commission may not occur until the following year. Nevertheless, deducting the commission expense in the year in which the sales income is reported results in a better matching of the commission expense with the sales income. Likewise, if income from the sale of goods is recognized in one year, but the goods are not shipped until the following year, the shipping costs are more properly matched to income in the year the goods are sold rather than in the year the goods are shipped.

Expenses such as insurance or rent generally can be allocated to a period and are best matched to that period. For example, a calendar year taxpayer with a twelve-month insurance contract entered into on July 1, 1984, generally should allocate one-half the expense to 1984 and one-half to 1985. (However, where the expense is an immaterial item, it is accruable in its entirety in 1984). Expenses such as advertising costs that cannot practically be associated with income of a particular period may be assigned to the period in which the costs are incurred (under generally accepted accounting principles). Congress intended that, in general, the matching requirement would be satisfied with respect to advertising expenses if the period to which the expenses are assigned for tax and financial reporting purposes is the same.

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[3] See APB Statement No. 4, *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises*, para. 155.

Modifications and clarifications with respect to economic performance standard

Interest

In the case of interest, economic performance occurs with the passage of time (that is, as the borrower uses, and the lender foregoes use of, the lender's money) rather than as payments are made. Interest incurred by accrual method taxpayers with respect to debts incurred in transactions occurring after June 8, 1984, the date of conference action, will be deductible only on a constant interest basis. (See sec. 44 of the Act relating to the effective date of the OID and unstated interest rules). Interest on obligations issued on or prior to that date are not subject to the statutory prohibition against noneconomic accruals of interest. However, Congress intended no inference regarding the propriety of interest accruals with respect to such obligations that are inconsistent with the principles stated in Rev. Rul. 83-84, 1983-1 C.B. 97.

Payments for nuclear waste disposal

Congress anticipated that the Treasury Department would issue regulations providing that economic performance with respect to amounts paid under the Nuclear Waste Disposal Act of 1982 occurs as payments are made to the Federal government.

Natural gas refunds

Regulated natural gas utilities may receive refunds from their suppliers for amounts they have been overcharged. Generally, these refunds are made to the utilities pursuant to regulatory commission orders and must be passed through to customers, usually within 8 to 12 months after receipt. Rev. Rul. 63-182, 1963-2 C.B. 194, which interpreted the all events test under prior law, permitted a utility to deduct the amount refunded to customers in the year the refunds were received by the utility rather than in the year the refunds were passed through to customers.

Congress intended that the Treasury Department have authority under the Act to provide that, in the case of natural gas supplier refunds, a utility may deduct such refunds in the year the refund is included in the income of the utility, provided that the refunds are passed through to consumers within a reasonable period of time in the following taxable year and that adequate interest is paid over to and includible in the income of the consumers.

Reliance on other existing rulings and regulations

Congress expected that the Treasury Department would review existing regulations and rulings to determine whether they are consistent with the policies and principles set forth herein. Until new regulations are issued under these provisions or the existing rulings are revoked or clarified, taxpayers may continue to rely on these rulings to the extent they are not inconsistent with the general principles of economic performance or the generic exception for recurring items.

Contested liabilities

The Act provides that an amount transferred to a section 461(f) trust with respect to a contested liability may not be deducted any earlier than when economic performance with respect to the liability occurs. For example, the Act provides that, in the case of workers' compensation or tort liabilities of the taxpayer requiring payments to another person, economic performance occurs as payments are made to that person. Since payment to a section 461(f) trust is not a payment to the claimant, such payment does not satisfy the economic performance test.

Proof of compliance with economic performance standard

Congress intended that enforcement of compliance with the economic performance standard be carried out in a manner that does not impose substantial additional recordkeeping burdens on taxpayers. In the absence of unusual circumstances, the existence of a valid contract requiring another person to provide property or services to the taxpayer prior to the end of the taxable year (or 8-1/2 months thereafter in the case of recurring items) would be sufficient to establish compliance with the economic performance standard with respect to the taxpayer's liability for an expense reflected in such contract.

More lenient standards may be warranted where an item is incurred by a foreign corporation.[4] Congress recognized that information regarding economic performance, which in some cases must be obtained from third parties, may be especially difficult to obtain in this situation, particularly if the U.S. taxpayer owns only a minority interest in the foreign corporation. Congress expected that regulations to be prescribed by the Treasury Department could provide that economic performance might be treated as having occurred by a particular date if the best available evidence indicates that it has so occurred, so long as the taxpayer can establish economic performance under the usual standards by the time the item becomes relevant for U.S. tax purposes. However, Congress did not intend any reduction of the taxpayer's burden of proof in a case involving a foreign corporation.

Compensation for services

The Act provides that economic performance with respect to a liability to an employee for compensation generally occurs as the employee renders his or her services. For certain types of compensation, however, an employer's deduction for compensation or other benefits paid to an employee in a year subsequent to economic performance, or for a contribution to a welfare benefit fund, is subject to specific rules in the Code (as amended elsewhere in the Act) (Code secs. 83, 404, 404A, and 419). The timing of the employer's deduction is determined under these sections rather than section 461 and may occur at a time later than when economic performance occurs. Consequently, to the extent that sections 83, 404, 404A

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[4] Even if a corporation is not subject to U.S. tax jurisdiction, its taxable income may be relevant in determining the taxable income of a U.S. shareholder. Taxable income, and thus earnings and profits, of a foreign corporation must be determined according to U.S. tax principles, including the all events and economic performance tests.

and 419 apply, the rules under section 461(h), which determine whether an amount has been incurred, are not relevant; also, if an employer elects to accrue vacation pay under section 463, the economic performance rules specifically do not apply.

In many cases, however, the timing of an employer's deduction for employee compensation and benefits may not be determined under the rules of sections 83, 404, 404A, 419, or 463. For example, if a bonus is paid directly by an employer to an employee within a short period of time (generally 2 1/2 months) after the end of the taxable year in which the services to which the payment relates were performed, the rules of sections 404 and 419 do not apply, and thus, the employer's deduction for this form of compensation is governed by the economic performance rules.

Economic performance with respect to employee benefits (other than compensation) occurs generally when the employer makes a payment under the benefit plan (rather than when the services are rendered). Thus, contributions to a trust under a funded welfare benefit plan would be considered a payment under the plan for purposes of the economic performance test. It should be noted that the economic performance rules apply to amounts contributed to a funded welfare benefit plan before the effective date of section 419.

In cases in which employee benefits are subject to the economic performance rules of this provision, the exception to the economic performance rules for recurring items will often apply. For example, assume that a calendar-year employer does not elect to accrue vacation pay under section 463. Assume further that an employee earns two weeks of vacation during 1984. If the employee takes the vacation either during 1984 or before March 15, 1985, the employer is allowed a deduction in 1984 (provided that the recurring item exception requirements are satisfied). On the other hand, if the employee does not take the vacation until after March 15, 1985, the rules under section 404 generally apply to delay the deduction until the employee takes the vacation.

Carrybacks of net operating losses

The Act provides for a 10-year carryback period for certain deferred liability losses. A deferred statutory or tort liability loss means the lesser of (1) the net operating loss for the year reduced by any foreign expropriation or product liability loss; or (2) the amount allowable as a deduction under this provision which is taken into account in computing the net operating loss for the year and is for an amount incurred with respect to a statutory or tort liability. This rule applies, in the case of a liability under Federal or State law, if the act (or failure to act) occurs at least 3 years before the beginning of the taxable year and, in the case of a tort liability, if the liability arises out of a series of actions (or failures to act) over an extended period of time a substantial portion of which occurs at least 3 years before the beginning of the year. For example, this rule applies if a taxpayer incurs a tort liability for failure to protect another person from a hazardous substance, such as chemical waste, over an extended period of time more than 3 years before the year of payment.

The 10-year carryback rule will not apply unless the taxpayer used an accrual method of accounting throughout the period or periods during which the act (or failure to act) occurred.

The Act provides a special rule for the net operating loss carrybacks in the case of nuclear power plants (whether or not the taxpayer elects to deduct contributions to a reserve fund as provided by the Act). The amount of any net operating loss attributable to the decommissioning of nuclear power plants may be carried back to each of the taxable years during the period beginning with the taxable year in which the plant was placed in service. No net operating loss carrybacks resulting from nuclear decommissioning may be carried back to a taxable year before January 1, 1984, unless such loss may be carried back to such year without regard to these rules.

Effective Date

The Act applies to amounts with respect to which deductions would be allowable (determined without regard to the provisions of the Act) after July 18, 1984. However, the Act provides that taxpayers may elect (with respect to each type of deductible item) to apply the provisions of the Act to amounts with respect to which the all events test under prior law is met before July 19, 1984, and economic performance occurs after July 18, 1984. This election will be treated as a change in method of accounting that is initiated by the taxpayer, made with the consent of the Secretary of the Treasury, and with respect to which the spread of any section 481 adjustment is limited to 3 years.

Generally, taxable income and the amount of the section 481 adjustment is required to be computed as if the change in method of accounting occurred on July 19, 1984. However, in some cases, it may not be possible to determine taxable income and the amount of the adjustment as if the change occurs on that date. Accordingly, it is anticipated that the regulations could provide that, in such cases, the change in method of accounting occurs as of the first day of the taxable year that includes July 19, 1984, and the amount of the section 481(a) adjustment is computed as of the beginning of such taxable year.

The Act provides a special transitional rule for accrued vacation pay. Taxpayers with fully vested accrued vacation pay plans, who previously had not elected to treat vacation pay under the provisions of section 463, will be permitted under this rule to elect the application of section 463 for the first taxable year ending after July 18, 1984, with a special rule for determining the opening balance described in section 463(a)(1). Under this special rule, the opening balance of the account generally would be the amount determined as if such an account had been maintained for the previous taxable year (i.e., the amount determined under sec. 463(b)(1)). This rule is less restrictive than the general rule which requires that the opening balance be the amount equal to the largest closing balance the taxpayer would have had for any of the 3 preceding taxable years (sec. 463(b)(2)).

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $138 million in 1984, $429 million in 1985, $510 million in 1986, $491 million in 1987, $399 million in 1988, and $373 million in 1989.

2. Nuclear Power Plant Decommissioning Expenses (sec. 91 of the Act and new secs. 88 and 468A of the Code)[5]

Prior Law

Under prior law, an accrual-basis taxpayer could deduct an anticipated expense no sooner than the tax year in which (1) all events necessary for determining the existence of the liability had occurred, and (2) the amount of the liability could be determined with reasonable accuracy (Code sec. 461). It was unclear under prior law when nuclear power plant decommissioning expenses were properly accrued.[6]

Reasons for Change

The Congress believed that the establishment of segregated reserve funds for paying future nuclear decommissioning costs was of sufficient national importance that a tax deduction, subject to limitations, should be provided for amounts contributed to qualified funds. This departs from the general industry practice of deducting decommissioning expenditures at the end of plant life when decommissioning is performed. This provision also departs from the general principle, adopted in the Act, that accrual method taxpayers should deduct future liabilities when economic performance occurs. However, the Congress did not intend that this deduction should lower the taxes paid by the owners of a nuclear power plant in present value terms; instead, the provision was intended to spread the deduction of decommissioning expenses over the life of the plant as contributions are made to a qualified nuclear decommissioning fund.

Explanation of Provision

Under the Act, a taxpayer responsible for nuclear power plant decommissioning (the "taxpayer") may elect to deduct contributions made to a qualified nuclear decommissioning fund, subject to certain limitations. Taxpayers who do not elect this provision are subject to the general rules in the Act which do not permit accrual basis taxpayers to deduct future liabilities prior to the time when economic performance occurs (Code sec. 461).

A qualified nuclear decommissioning fund (a "fund") is a segregated fund established by the taxpayer after the date of enactment, and used exclusively for the payment of nuclear decommissioning costs, taxes on fund income, management costs of the fund, and in-

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[5] For legislative background of the provision, see "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 71; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 277-279; and H. Rept. 98-861 (June 23, 1984), pp. 877-879 (Conference Report).

[6] A more detailed discussion of prior law is presented in the "Premature Accruals" section of this explanation (item 1 above).

vestments in certain assets. A fund is not subject to tax as a trust, but is a separate taxable entity and is subject to tax at the maximum corporate income tax rate (46 percent).

Congress intended that a fund will be subject to the same rules as a Black Lung Disability Trust Fund (sec. 501(c)(21)) that: (1) limit investment to Federal, State, and local government obligations and bank and credit union deposits[7] and (2) prohibit self-dealing. It is intended that where responsibility for decommissioning a nuclear power plant is divided among taxpayers, each taxpayer may establish a fund for its share of the liability.

Under the Act, taxpayers must obtain a ruling from the Internal Revenue Service (IRS) to establish the maximum annual contribution that may be made to a fund. The ruling has two purposes: (1) to prevent accumulation of funds in excess of those required to pay future decommissioning costs (attributable to remaining plant life at the date the fund is established), and (2) to ensure that contributions to the fund are not accelerated (i.e., deducted more rapidly than level funding). For example, if two-thirds of a plant's useful life (not including the decommissioning period) remains when a fund is established, then the taxpayer's deduction would be limited to contributions necessary to pay two-thirds of the estimated future decommissioning cost, on a level funding basis. The IRS shall review the ruling amount at least once during plant life, or more frequently by petition of the taxpayer.

Contributions by the taxpayer to a qualified decommissioning fund are deductible, in the year made, but only to the extent these amounts are added to the taxpayer's cost of service for ratemaking purposes and charged to customers. Generally, withdrawals from a decommissioning fund are included in the taxpayer's gross income, in the year withdrawn. However, withdrawals used to pay taxes imposed on the fund and certain fund management costs are not included in the taxpayer's gross income unless paid to the taxpayer. The taxpayer may deduct decommissioning costs when economic performance occurs (Code sec. 461).

The gross income of a fund includes all investment income other than interest on tax-exempt bonds but does not include contributions to the fund (which are deductible to the taxpayer). Withdrawals from a fund are not generally deductible from its gross income. However, fund withdrawals used to pay State and local taxes[8] imposed on the fund and certain fund management costs are deductible from the fund's gross income unless paid to the taxpayer.

If a decommissioning fund fails to comply with the qualification requirements, it may be disqualified by determination of the IRS. In the event of disqualification, the IRS may require that some or all of the fund balance (i.e., principal plus accumulated interest) be included in the taxpayer's gross income. No deduction is allowed for contributions to a disqualified fund. In the year that plant decommissioning is substantially completed, the taxpayer must terminate the fund, and the balance of the fund must be included in the taxpayer's gross income. Congress intended that the Treasury will

[7] A technical amendment may be necessary to reach this result.

[8] A technical amendment may be necessary to clarify that Federal taxes are not deductible from the fund's gross income.

issue regulations that define when decommissioning is substantially complete.

In the event that a nuclear power plant, or any interest therein, is sold or otherwise disposed of prior to completion of decommissioning, the seller's decommissioning fund will be treated as disqualified. Congress intended that a buyer will be allowed, at the discretion of the IRS, to make a one-time deductible contribution, in excess of the annual ruling amount, to a new decommissioning fund. However, the buyer's start-up contribution is in all cases limited to the balance of the seller's qualified decommissioning fund immediately prior to the sale.

The Act also provides (sec. 91(f)) that all customer charges for nuclear decommissioning expenses, whether or not contributed to a qualified fund, must be included in the taxpayer's gross income (Code sec. 88).

Effective Date

These provisions are effective after the date of enactment (July 18, 1984).[9]

Revenue Effect

The revenue effect of this provision is included in the revenue effect of the "Premature Accruals" section of this explanation (item 1 above).

[9] A technical amendment may be necessary to clarify these effective dates.

3. Mine Reclamation and Similar Costs (sec. 91 of the Act and new sec. 468 of the Code)[10]

Prior Law

Under prior law, an accrual-basis taxpayer could deduct an anticipated expense no sooner than the tax year in which (1) all events necessary for determining the existence of the liability had occurred, and (2) the amount of the liability could be determined with reasonable accuracy (sec. 461).

Federal and State laws (and certain municipal permits and ordinances) require reclamation of surface mines and waste disposal sites. The Internal Revenue Service has taken the position that reclamation expenses cannot be accrued until reclamation occurs. Notwithstanding the Service position, the Tax Court in *Ohio River Collieries v. Commissioner* (77 T.C. 1369 (1981)) held that surface mining reclamation costs that could be estimated with reasonable accuracy were properly accrued when the overburden was removed.[11]

Reasons for Change

Under prior law, companies used a variety of accounting methods for accruing reclamation costs. The Act provides electing taxpayers a uniform method for deducting, prior to economic performance, reclamation costs which are mandated by Federal or State law. Congress believed that accounting methods which resulted in more accelerated deductions for reclamation costs provided unwarranted tax benefits and, subject to transition rules, the use of such methods is prohibited by the Act.

This elective method of deducting reclamation costs departs from the general principle, adopted in the Act, of allowing a deduction for future liabilities only when economic performance occurs. Congress believed that in the case of mine reclamation and closing costs (and reclamation costs associated with the disposal of solid, liquid, or hazardous waste), more liberal rules are appropriate.

Explanation of Provision

Under the Act, taxpayers may elect a uniform method of deducting qualified mine and waste disposal site reclamation and closing costs prior to economic performance. Taxpayers who do not elect this provision are subject to the general rules in the Act which do

[10] For legislative background of the provision, see "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 71; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 274-276; and H. Rpt. 98-861 (June 23, 1984), pp. 879-883 (Conference Report).

[11] A more detailed discussion of prior law is presented in the "Premature Accruals" section of this explanation (item 1 above).

not permit accrual basis taxpayers to deduct future expenses prior to the time when economic performance occurs (Code sec. 461).

Expenses incurred for land reclamation or closing activities that are conducted at mine sites in accordance with a reclamation plan or permit pursuant to the Surface Mining Control and Reclamation Act of 1977, or other Federal and State laws imposing substantially similar requirements, are qualified costs for the purposes of this provision. Similarly, expenses incurred for any land reclamation or closing activities conducted at a solid waste disposal site subject to the requirements of the Solid Waste Disposal Act, or other Federal, State, and local laws which impose substantially similar requirements, are qualified costs for the purposes of this provision. However, no deductions for waste disposal site reclamation and closing costs may be claimed under this provision for properties listed in the national contingency plan established under section 105 of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980.

The Act provides that electing taxpayers may deduct the estimated current cost of reclaiming land that is disturbed during the current tax year at mines and waste disposal sites. Electing taxpayers may also deduct the estimated current cost of certain site closing costs allocable to ore removed (wastes deposited) during the tax year, based on the units-of-production (units-of-capacity) method of account.

For example, if 20 acres of overburden are removed from a surface mine during the current tax year and the estimated per acre cost of reclamation (in current dollars) is $10, then $200 of reclamation costs may be deducted in that year. In the case of closing costs, if remaining site capacity is 500 tons of ore, 50 tons are produced during the current tax year, and the estimated unrecovered current cost of site closing (i.e., the current cost of closing the site less prior deductions taken for site closing costs) is $1,000, then $100 of site closing costs may be deducted in that year under the units-of-production method of account.

Under the elective method provided by the Act, all amounts deducted for site reclamation costs are deemed deposited, in the year deducted, in a site-specific, tax-exempt reclamation sinking fund. Similarly, all amounts deducted for site closing costs are deemed deposited in a tax-exempt site closing sinking fund in the year deducted.[12] The site reclamation and closing funds are deemed to earn interest according to the following schedule: 70 percent of the short-term rate provided in Code section 1274 (compounded semiannually) in tax years ending in 1984 and 1985, 85 percent in 1986, and 100 percent in tax years ending on or after January 1, 1987.

Amounts expended for qualified reclamation and site closing activities, allocable to land disturbed or units of production (capacity) subsequent to the date of election, are deemed withdrawn from the applicable sinking fund in the year paid. The excess of such amounts paid for reclamation and closing costs over the year-end sinking fund balances (after deemed deposits and interest and before deemed withdrawals in the current tax year) is deductible in

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[12] A technical amendment may be necessary to achieve this result.

the year paid. Therefore, amounts paid for the performance of site reclamation (closing) are not deductible except for the excess over the site reclamation (closing) sinking fund balance (since amounts deposited in the sinking fund were previously deducted).

For example, assume the taxpayer's start of year site reclamation sinking fund balance is $200. The estimated current cost of reclaiming land disturbed during the tax year is $100 which the taxpayer deducts and is deemed deposited in the site reclamation sinking fund. If the deemed interest rate is 7 percent after compounding (determined according to the schedule above), then the end of year balance is $314 (i.e., $200 plus $100 of deposits plus $14 of interest) prior to deemed withdrawals. If $400 is spent on qualified site reclamation costs during the tax year, allocable to land disturbed after the date of election, then the end of year reclamation sinking fund balance is reduced to zero, and $86 ($400-$314) of these reclamation expenditures are deductible.

Under the Act, the balances of the site reclamation and site closing sinking funds are subject to limitations. Amounts in the site reclamation and closing sinking funds in excess of these limits, at the end of each tax year (after deemed deposits, interest, and other withdrawals), are deemed withdrawn and are included in that year's taxable income.

The balance of the site reclamation sinking fund, at the end of each tax year, is limited to the current cost of reclaiming land that has been disturbed, subsequent to the date of election, but not previously reclaimed. For example, if at the end of the first tax year after the date of election 20 acres have been disturbed, and the current per acre cost of reclamation is $10, then $200 (20 x $10) may be deducted in that year, and the sinking fund balance is limited to the same amount. If at the end of the second tax year 20 additional acres have been disturbed, the per acre cost of reclamation has risen to $11, then $220 (20 x $11) may be deducted in that year, and (if the previous 20 acres have not been reclaimed) the sinking fund balance is limited to $440 (40 x $11).

Similarly, the balance of the site closing sinking fund, at the end of each tax year, is limited to the current cost of closing the portion of the site which has been utilized (based on a cumulative units-of-production or units-of-capacity method), subsequent to the date of election. For example, suppose that remaining site capacity (as of the date of election) is 500 units, 100 units are produced during the first year after the date of election, and the current cost of closing the portion of the site which was unused as of the date of election is $1,000. In this case, $200 ($1,000 x 100/500) may be deducted in that year, and the sinking fund balance is limited to the same amount. If at the end of the next tax year an additional 100 units are produced, and the current cost of closing the portion of the site which was unused as of the date of election has risen to $1,100, then $225 may be deducted (i.e., the unrecovered cost of current site closing, $900, times the proportion of remaining units produced during the tax year, 100/400), and the fund balance is limited to $440 ($1,100 x 200/500).

In the case of mining, a site is defined as a "property" within the meaning of Code section 614. It was intended that the election to deduct reclamation and closing costs under this provision must be made for a site in its entirety. Where an election is made and responsibility for site reclamation and closing is divided between taxpayers with an interest in the site, each taxpayer may claim deductions for its share of the liability. For each site, the election may be revoked by the taxpayer; however, the balance of the site reclamation and closing funds must be included in gross income in that tax year, and the election may not be reinstated.

If a mine or waste disposal site is sold or otherwise disposed of prior to completion of site reclamation and closing, it is intended that the seller will recognize the outstanding balances of site reclamation and site closing sinking funds in gross income. If any portion of the site is disposed of, then this portion of the site's reclamation and closing funds are subject to recapture. Recapture of sinking fund balances is also required at the end of the tax year in which a waste disposal site is listed in the National Contingency Plan.

Effective Date

This provision is effective after the date of enactment (July 18, 1984).[13]

Under the Act, a fixed price mineral supply contract transition rule applies on a pro rata basis according to units of production. For example, if site production is 100 tons in a tax year, of which 40 tons is sold pursuant to a fixed price supply contract, then only 40 percent of the site reclamation and closing costs allocable to that year are deductible in that year (but no more than the current dollar estimate of such costs). If an election were made, then the remaining 60 percent of site reclamation and closing costs would be deductible, under the uniform method provided by the Act.

Minerals are considered sold subject to a fixed price agreement if prices are determined strictly in accordance with a formula which was fixed as of March 1, 1984, and the agreement does not permit, either directly or indirectly, adjustment for changes in tax liability. This transition rule does not apply to price agreements that are extended beyond the period in effect as of March 1, 1984, or whose terms or conditions have been renegotiated or changed from those in effect as of March 1, 1984.

Revenue Effect

The revenue effect of this provision is included in the revenue effect of the "Premature Accruals" section of this explanation (item 1 above).

[13] A technical amendment may be necessary to clarify the effective date.

4. Prepayments of Expenses (sec. 91 of the Act and new sec. 461(i) of the Code)[13A]

Prior Law

In general

A taxpayer is generally allowed a deduction in the taxable year which is the proper taxable year under the method of accounting used in computing taxable income (Code sec. 461). The two most common methods of accounting are the cash receipts and disbursements method and the accrual method. If, however, the taxpayer's method of accounting does not clearly reflect income, the computation of taxable income must be made under the method which, in the opinion of the Internal Revenue Service, clearly reflects income (sec. 446(b)). Furthermore, the income tax regulations provide that if an expenditure results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year, such an expenditure may not be deductible, or may be deductible only in part, for the taxable year in which paid by a taxpayer using the cash receipts and disbursements method of accounting, or in which incurred by a taxpayer using the accrual method of accounting (Treas. Reg. sec. 1.461-1(a)(1) and (2)).

Deductions for interest

Under the cash receipts and disbursements method of accounting, deductions generally are allowed in the year in which the expenditures are paid. Under present and prior law, if a taxpayer uses the cash receipts and disbursements method to compute taxable income, interest paid by the taxpayer which is properly allocable to any later taxable year is generally treated as paid in the year to which it is allocable; interest is allocable to the period in which the interest represents a charge for the use or forbearance of borrowed money (sec. 461(g)). An accrual method taxpayer can deduct interest (whether or not prepaid) only in the period in which the use of money occurs. Thus, under present and prior law, interest is deductible in the same period for both cash and accrual method taxpayers.

Deductions other than interest

Prior law is unclear as to the proper timing of a deduction for prepaid expenses, other than interest. While a cash basis taxpayer generally may deduct expenses when paid, such deductions are not

[13A] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 91; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1258-1261; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 71; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 270-273; H. Con. Res. 328, 130 Cong. Rec. S. 8943 (June 29, 1984), H 7525 (June 29, 1984); and H. Rep. No. 98-861 (June 23, 1984), pp. 883-885 (Conference Report).

allowed, however, to the extent that they result in a material distortion of income.

Generally, the courts have examined all the facts and circumstances in a particular case to determine whether allowing a full deduction for the prepayment would result in a material distortion of income. In determining whether an expenditure results in the creation of an asset having a useful life extending substantially beyond the end of the taxable year, the court in *Zaninovich* v. *Commissioner*, 616 F.2d 429 (9th Cir. 1980), adopted a "one-year" rule. Under this rule, prepayments generally may be deducted if they do not provide benefits that extend beyond one year. Thus, under this decision, a calendar-year, cash-basis taxpayer may be able to deduct a lease payment for the next year paid in December of the current year. (However, see *Grynberg* v. *Commissioner,* 83 T.C. 255 (1984).)

Special rule for farm syndicates

Present and prior law provides limitations on deductions in the case of farming syndicates. A farming syndicate is allowed a deduction for amounts paid for items (such as feed) only in the year in which such items are actually used or consumed or, if later, in the year otherwise allowable as a deduction. A farming syndicate is defined generally as a partnership or any other enterprise (other than a corporation which is not an S corporation) engaged in farming if (1) interests in the partnership or enterprise have been offered for sale in any offering required to be registered with any Federal or State agency, or (2) if more than 35 percent of the losses during any period are allocable to limited partners or limited entrepreneurs (i.e., persons who do not actively participate in the management of the enterprise).

Reasons for Change

Many tax shelters relied on the deductibility of year-end payments for expenses allocable to the following and subsequent taxable years. By deducting the full amount of prepayments, cash basis taxpayers could shelter other income and reduce Federal income taxes merely by making prepayments of expenses (other than interest). Taxpayers could benefit significantly, for example, by borrowing funds and making prepayments to accelerate deductions into a high-income year when lower income was anticipated in future years. The benefits could be significant even when the deduction was accelerated only for one year. Congress believed, therefore, that a taxpayer should not be allowed deductions for expenses until the period to which the expenses are allocable.

Congress recognized, however, that in numerous everyday business transactions expenses are prepaid. To avoid an adverse impact on these normal business transactions, Congress believed that it was appropriate to limit the application of this new rule to tax shelters. Thus, the new rule applies only where the abuse is most serious. Congress also believed that an exception to this rule should be provided for prepaid expenses where economic performance occurs within a short period (90 days) after the end of the taxable year because, in these cases, the potential for abuse is less serious.

However, Congress intended that, in order to prevent a deduction for amounts prepaid with borrowed funds, this exception be limited to the taxpayer's cash investment in the tax shelter. Furthermore, Congress did not intend any negative inference with respect to prepayments of expenses outside the tax shelter context; as under present and prior law, a taxpayer would not be allowed to deduct the amount of an expense if such a deduction would result in a material distortion of income.

Congress believed that, in order to equalize the treatment of cash and accrual basis farming tax shelters, the timing rules for farm syndicates under section 464 should apply to both cash and accrual basis farming tax shelters as defined in the Act.

Explanation of Provision

Under the Act, a tax shelter computing taxable income under the cash receipts and disbursements method is not allowed a deduction with respect to any amount earlier than the time at which such amount is treated as incurred. An amount is not treated as incurred at any time earlier than the time at which economic performance occurs. For this purpose, the recurring item exception to the economic performance requirement (see Item 1, *supra*) does not apply. Thus, a cash basis tax shelter may not deduct an amount until both economic performance occurs and the amount is paid.

The time at which economic performance occurs generally means when services are performed, property provided, use of property occurs or when the liability is otherwise satisfied.[14] When economic performance occurs, and in the case of a cash basis tax shelter, the amount is paid, the amount is treated as paid or incurred for all purposes of the Code. For example, research and experimental expenditures are treated as incurred when the research and experimentation work is performed, at which time the expenditures are allowed as a deduction if the taxpayer so elects under section 174. Likewise, mine development expenditures are treated as incurred when the mine development activity is performed. At the election of the taxpayer under section 616, such expenditures may be deducted at that time. Also, management fees are treated as incurred when the management services are rendered.

Certain exceptions are provided under which prepaid expenses of a cash basis tax shelter are deductible when paid if economic performance occurs within 90 days after the end of the taxable year in which the prepayment is made. However, the maximum deduction that is allowable for any prepaid expenses under this exception is limited to the cash basis of the taxpayer in the tax shelter. For this purpose, the cash basis in a tax shelter which is a partnership is the taxpayer's basis in the partnership determined without regard to (1) any liabilities of the partnership (with or without recourse), (2) any borrowings of the partner that are arranged by the organizer or promoter of the tax shelter, and (3) any borrowings of the partner that are secured by the partnership interest or any assets of the partnership. In the case of tax shelters that are not partner-

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[14] For a more detailed description of the definition of economic performance, see section 461(h) as added by the Act.

ships, similar rules apply. Thus, in the case of individual tax shelters, the cash basis does not include any amounts borrowed by the individual which are arranged by the organizer or promoter or are secured by the tax shelter interest or any assets of the tax shelter.

For purposes of the 90-day exception only, in the case of oil and gas activities, economic performance is deemed to occur with respect to all intangible drilling expenses of a well when the well is "spudded." For example, if a taxpayer contributed cash (not out of borrowings arranged by the tax shelter) to an oil drilling tax shelter in late December of a taxable year and the spudding of the well commenced within 90 days after the close of the taxable year, the entire amount of the prepaid intangible drilling expense would be deductible, subject to the limitations of present and prior law requiring that the prepayment not be a deposit, that it be made for a business purpose, and that it does not result in a material distortion of income. Similarly, if the spudding of the well commenced in December, the 90-day rule would apply because the spudding occurs before the 90th day after the close of the taxable year. In such a case, that portion of the intangible drilling expenses attributable to drilling prior to the end of that year will be deductible without regard to the cash basis limitation. Whether spudding occurs in December, or any time before the 90th day after the close of the taxable year, that portion of the intangible drilling costs not attributable to the taxable year is subject to the cash basis limitation.

To the extent that oil and gas prepayments do not meet the requirements of the 90-day exception, they are subject to the general principles applicable to prepaid expenses; thus, economic performance occurs as the drilling services are provided to the taxpayer.

With respect to expenses incurred in the trade or business of farming, section 464 will be applied before the prepaid expense provisions, and accrual method tax shelters will be subject to the timing rules of section 464. Thus, to the extent that section 464 applies to a prepaid expense, the 90-day exception does not apply. For example, assume that a calendar year farming tax shelter prepays expenses for feed in December 1985 and the feed is consumed in February 1986 (i.e., within 90-days after the close of the taxable year). The prepaid feed expense may not be deducted until 1986—the year it is used or consumed as provided in section 464. However, if the farming tax shelter prepays rent in December 1985 for the period January through March, 1986, the 90-day exception would apply because section 464 does not apply to rent expenses. Thus, the prepaid rent would be deductible when paid in 1985 (subject to the cash basis limitation and other applicable provisions in the Code, for example, the clear reflection of income standard under section 446(b)).

The prepaid expense provisions apply to individual taxpayers engaged in farming activities with the principal purpose of tax avoidance. Congress intended that marketed arrangements in which individuals carry on farming activities utilizing the assistance of a common managerial or administrative services may be presumed under certain circumstances to have the principal purpose of tax avoidance. However, marketed arrangements do not include certain activities where the tax benefits are not promoted. For example, assume that a cattle feeding advisor introduces its feeding services to customers, either through personal contact, advertising in agricultural trade publications, or a brochure that explains customary services that does not in any way promote tax benefits in such contact, advertising or brochures. These services may include daily care and feeding of cattle, assistance in cattle and grain buying, financing cattle and feed, hedging and cattle sales. Under these circumstances, the activities of the advisor are not to be considered a marketed arrangement for purposes of this provision. If, under an arrangement that is considered a marketed arrangement, taxpayers prepay a substantial portion of their farming expenses with borrowed funds, they should generally be presumed to have a principal purpose of tax avoidance.

Neither the general rule requiring economic performance to occur before a deduction is allowable nor the 90-day exception overrides any limitations of present and prior law on the deductibility of prepaid expenses, including the requirement of a payment rather than a deposit, a business purpose for the prepayment, and no material distortion of income.

Under the Act, a tax shelter means (1) a partnership or other enterprise (other than a corporation which is not an S corporation) in which interests have been offered for sale, at any time, in any offering required to be registered with a Federal or State agency; (2) a partnership or other enterprise if more than 35 percent of the losses are allocable to limited partners or limited entrepreneurs (generally investors who do not actively participate in the management of the enterprise); or (3) any partnership, entity, plan, or arrangement which is a tax shelter within the meaning of section 6661(b) (i.e., the principal purpose of which is the avoidance or evasion of Federal income tax.) In the case of the trade or business of farming, the definition of a farming syndicate in section 464(c) is substituted for the tests in (1) and (2) above to determine whether the entity is a tax shelter. Congress intended that an offering required to be registered with any Federal or State agency will include any offering filed with, or with respect to, which notice is given to such agency.

In determining whether an investment constitutes a tax shelter, Congress intended that consideration will be given to whether there is a reasonable and significant expectation that either (1) deductions in excess of income from the investment being available in any year to reduce income from other sources in that year, or (2) credits in excess of the tax attributable to the income from the investment being available in any year to offset Federal income taxes on income from other sources in that year. Whether an investment is intended to have tax shelter expectations will depend on the objective facts and circumstances of each case. Significant weight will be given to the expectations described in the offering materials to determine whether the investment is a tax shelter. In addition, significant weight will be given to the percentage of total expenses of the entity, plan, or arrangement that are prepaid expenses.

Effective Date

The provision applies to amounts with respect to which a deduction would be allowable under prior law after March 31, 1984.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $108 million in 1984, $243 million in 1985, $76 million in 1986, $93 million in 1987, $112 million in 1988, and $133 million in 1989.

5. Treatment of Certain Payments for Use of Property or for Services (sec. 92 of the Act and new sec. 467 of the Code)[15]

Prior Law

Deferred payments for use of property

Under prior law, the timing of inclusion of rental income or deduction of rental expense depended upon the taxpayer's method of accounting. A lessor on the cash method of accounting included rent in income in the year in which the rent was actually or constructively received. A lessor on the accrual method reported rental income in the year in which all events fixing the lessee's liability for the rent had occurred and the amount of the liability could be determined with reasonable accuracy (the "all-events test").

A cash-method lessee for whom rent was a deductible expense was allowed a deduction in the year of payment; an accrual-method lessee was allowed a deduction in the year the all-events test was satisfied.

In the case of a multiple-year lease calling for payment of rent in a lump sum at the end of the lease term, an accrual-method lessee might deduct annually a ratable portion of the total rent, on the theory that this portion of its liability was fixed annually. A cash method lessor under such a lease might take the position that income was realized only in the year of receipt, thus deferring income inclusion until the end of the lease term.

It was unclear under prior law under what circumstances uneven rent schedules—whereunder rents increase over the lease term (so-called "stepped" rents) or decrease over the lease term—would be treated as resulting in deferral or prepayment of rent.[16] The Internal Revenue Service had issued a revenue procedure stating that the payment of uneven rents in a leveraged lease ordinarily would not be regarded as involving a deferral or prepayment of rent, provided the rent payable for any year did not exceed 110 percent of the average annual rent payable over the term of the lease and was not less than 90 percent of this average (Rev. Proc. 75-21,

[15] For legislative background of the provision, *see*: H.R. 4170, committee amendment approved by House Committee on Ways and Means on March 1, 1984, sec. 44; H.R. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1249-1250; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 74; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 260-263; Senate floor amendment, 130 Cong. Rec. S. 4489-4491 (April 12, 1984); and H.R. Rep. No. 98-861 (June 23, 1984), pp. 889-895 (Conference Report); and H. Con. Res. 328, 130 Cong. Rec. S. 8944, H. 7525 (June 29, 1984).

[16] Assuming, arguendo, that rents accrue ratably over the term of a lease as an economic matter, a lease calling for lower payments of rent in the early years and higher payments in later years achieves income deferral in the same manner as a lease requiring no payments of rent until the end of the lease term, although to a lesser degree. Conversely, a decreasing rent schedule creates a prepayment in the early years of the lease of a portion of the rent for the later years.

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1975-1 C.B. 715).[17] This revenue procedure was applied, however, only in the case of personal property leases.

The original issue discount rules (secs. 1232 and 1232A of prior law) requiring annual inclusion and deduction of deferred interest, did not apply to debt obligations arising from the use of property by the obligee unless the obligation was publicly traded.

Deferred payments for services

Under both prior and present law, deferred payments for services are subject to the timing rules of section 404 or 404A if made pursuant to a "plan deferring the receipt of . . . compensation." Under sections 404 and 404A, amounts paid or accrued to an employee or independent contractor under a nonqualified plan of deferred compensation are deductible by the payor only in the year in which the compensation is included in the income of the recipient. Prior law was unclear as to whether all forms of compensation were subject to these provisions.

The original issue discount rules did not apply to debt obligations arising from the performance of services for the obligee unless the obligation was publicly traded.

Reasons for Change

Deferred payments for use of property

Mismatching of income and deductions

Congress was concerned that a number of taxpayers were taking advantage of the tax accounting rules under prior law to achieve substantial, unwarranted tax benefits from leases of property. In some cases, these benefits were achieved by deferring some or all payments of rent for a significant period of time, sometimes until the end of the lease; in other cases, they were achieved by "stepping" rents.

Under prior law, an accrual-method lessee under a lease calling for payment of all rent at the end of the lease term generally deducted a ratable portion of the total rent due annually over the lease term. The cash-method lessor, however, included this rent in income only in the year when payment was received. Thus, while the lessee's deductions were preserved, the lessor's inclusion of rent income arguably could be deferred.

A lease calling for stepped rents allowed a similar (though less dramatic) deferral of the lessor's income and, in some cases, created a mismatching of the lessor's income and the lessee's deductions. Stepped rents were employed in many tax shelter sale-lease-

[17] Although the principal purpose of Rev. Proc. 75-21 was to set forth the circumstances in which the Service would issue a ruling that an agreement was a lease rather than a financing arrangement, compliance with the guidelines relating to uneven rents was generally a precondition to issuance of a favorable ruling, and the guidelines were widely followed in the leasing industry. Rev. Proc. 75-21 also provided an alternative test based on rents payable over the first two-thirds of the lease term. This test was satisfied if (1) during at least the first two-thirds of the lease term, the annual rent for any year was not more than 10 percent above or below the average rent over this portion of the lease term, and (2) the annual rent for any year during the remainder of the lease term was no greater than the highest annual rent for any year during the initial portion of the lease term, and no less than one-half the average annual rent during this period.

back transactions, sometimes in conjunction with so-called "sandwich" leases.

In a sandwich lease transaction, a cash-method partnership (often set up by a syndicator for purposes of the transaction) was simultaneously a lessee under a master lease with the ultimate owner of the property and a lessor under a sublease of the same property. The only practical function of this partnership was to collect rents from the sublessee, the ultimate user of the property, and pass on these rents (minus a fee for its services) to the lessor.[18] The master lease and the sublease were for the same duration and contained substantially identical terms with respect to annual payments of rent: low rents in the early years and much higher rents in the later years. (In one syndicated transaction brought to Congress' attention, the leases provided for annual payments of rent of approximately $4 million in each of the first five years, escalating to approximately $20 million in each of the years 16 through 25.) The sublease provided that the total rent due under the lease accrued ratably over the lease term. The master lease, however, contained no such provision.

The sublessee (an accrual-method taxpayer) would accrue annually a level amount of rent reflecting the average rent payable over the term of the lease. The ultimate lessor (also an accrual-method taxpayer) accrued annually only the amount of rent actually received from the cash method partnership. The partnership reported exactly offsetting rental income and deductions, except for amounts retained as fees.

Congress believed that the potential for income deferral and mismatching of rental income and expense leases should be eliminated in the case of large leasing transactions by requiring the lessor and lessee in such transactions to report consistent amounts on an accrual basis.[19] Congress believed that, if the parties report rents on an accrual basis, the amount of rent allocated to a particular period under the lease generally can be respected for tax purposes. If the tax brackets of the lessor and lessee are roughly equal, a natural tension exists between the parties. The lessor defers recognition of income at the cost to the lessee of a deduction to which it would otherwise be entitled. The decrease in the lessor's tax liability attributable to deferral approximates the increase in the lessee's liability attributable to the lost deduction. Only if circumstances suggest that the rent structure is designed to avoid taxes, Congress believed, should a different allocation be imposed for tax purposes.

Moreover, Congress believed that, if rents are not paid on a substantially current basis, an interest element is present as an economic matter. A lessor can be expected to demand from a lessee an amount reflecting the lessor's forbearance of the use of any rents

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[18] One variation of this device involved interposing of a tax-exempt entity as the lessee-sublessor.

[19] By the enactment of this provision, Congress intended no inference as to the ability of the Internal Revenue Service to challenge deferred-payment or stepped-rent leases, including sandwich lease transactions, under existing law. Specifically, no inference was intended as to the ability of the Internal Revenue Service to challenge the form of an agreement involving deferred rents under general accrual or clear reflection of income principles, on the ground that a purported lease constitutes a mere financing transaction, or on other grounds.

not paid during the period to which they are attributable, just as a seller of goods demands interest from a purchaser in a deferred-payment sale of property. Congress believed this interest element should be recognized for tax purposes and that, consistent with the treatment of deferred interest under the original issue discount rules, this interest should be reported on an accrual basis.

Conversion of ordinary income into capital gain

Congress believed that a stepped-rent lease also created the potential for conversion of ordinary rent income into capital gain. If the lessor sold the property or the lease before the "crossover" point—the point at which the rent payable annually exceeded the average rent for the lease term—the sales price would reflect the above-market rents payable over the remaining lease term. The excess of the average (market rate) rent over the rent actually paid in the years prior to the sale would be taxed to the lessor at long-term capital gain rates in the year of sale (or in later years if the installment method applied), rather than as rental income in the year to which the rent relates.[20]

Deferred payments for services

Congress believed that (subject to certain *de minimis* exceptions) where payments for services outside the scope of sections 404 and 404A are deferred substantially beyond the period to which they relate, the implicit interest element should, for tax purposes, be recognized by the parties on an accrual basis.

Explanation of Provision

Overview

The Act provides that the lessors and lessees under a "section 467 rental agreement" generally must report rental income and deductions using the accrual method of accounting, unless the total payments under the lease do not exceed $250,000. A section 467 rental agreement is a lease involving either (1) deferral of a rental amount beyond the end of the year following the calendar year to which the amount relates, or (2) an increase in rents from one period to the next over the lease term. Thus, the provision generally applies both in cases where rent is payable in a lump sum at the end of the lease term (unless the lease is for a term of two years or less) and in cases where rents are stepped.

The amount accrued for a particular taxable year is generally the amount allocated to this period under the lease. However, if the transaction is a "leaseback" or a "long-term agreement," and a principal motive of the stepping of rents is tax avoidance, rents are deemed to accrue on a level, present-value basis, and interest is deemed to accrue on the excess of accrued rents over rents actually paid. Safe harbors are provided under which certain rent increases (e.g., those based on increases in price indices or other factors not

[20] Although the Internal Revenue Service might succeed in treating this excess as ordinary income to the lessor under the theory that it represents a substitute for ordinary income or on some other theory, this result is unclear.

subject to manipulation) are deemed not motivated by tax avoidance.

Lessors in sale-leaseback transactions and long-term agreements who (by virtue of having demonstrated no tax avoidance purpose) are not subject to rent leveling during the term of the lease are subject to a recapture provision on disposition of the leased property. Under this recapture provision, any gain realized on such a disposition is treated as ordinary to the extent of the excess of (1) the accruals that would have been taken into account if the lessor had been subject to rent leveling over (2) the actual accruals of rent up to the date of transfer.

Accrual reporting for section 467 rental agreements

The parties under a section 467 rental agreement must report rental income and deductions on an accrual basis. The amount of rent accrued for a particular period is "determined by allocating rents in accordance with the agreement," except in the case of a "disqualified" leaseback or long-term agreement. A lease is disqualified if a principal purpose of the rent structure is tax avoidance or if the lease contains no allocation of rents.[21] The amount of rent accrued under a disqualified leaseback or long-term agreement is the "constant rental amount."

The parties to a section 467 rental agreement also must accrue annually any stated or imputed interest on accrued but unpaid rents, whether the rents are allocated according to the lease or under the provision requiring constant rental accrual. Interest accrues on any accrued but unpaid rent (and on any accrued interest) at a rate equal to 110 percent of the applicable Federal rate, compounded semiannually.[22]

Congress intended that any rent or interest accrued under this provision but not paid be treated as if it were a receivable of an accrual-method taxpayer previously reflected in income. Thus, if the lessee due to bankruptcy or other circumstance ultimately fails to pay any rent or interest accrued under this provision when due, the lessor may claim a bad debt deduction at the time and to the extent a bad debt deduction is allowed under existing law to an accrual-method taxpayer.[23] Similarly, a lessee under a section 467 rental agreement will have income under discharge of indebtedness or tax benefit principles to the extent a rental or interest amount previously accrued pursuant to this provision is forgiven or otherwise goes unpaid.

Accrual in accordance with agreement

The amount of rent allocable to a lease period under a section 467 rental agreement is the amount specified as due or payable with respect to the period, whether or not payable currently. If amounts are allocable to a period but are not payable by the close

[21] The terms "leaseback" and "long-term agreement" and the tax avoidance standard are discussed below under the heading "Accrual of constant rental amount."

[22] The Federal rate is a rate determined under section 1274(d), as added by the Act. The applicable rate is the rate, in effect at the time the lease is entered into, for debt instruments having a maturity equal to the term of the lease.

[23] This deduction will be allowed without regard to whether a valid debt exists for State law purposes.

of that period, the amount of rent (and interest) to be accrued is determined, based on present value concepts, in accordance with Treasury regulations. Congress expected that these regulations might provide different methods for determining the amount of rent to be accrued, depending on the type of lease involved.

Accrual of constant rental amount

If a lease constitutes a "disqualified leaseback or long-term agreement," the amount of rent to be accrued by the parties for any taxable year is the portion of the "constant rental amount" allocable to the year.

Leaseback or long-term agreement

A leaseback transaction is a lease by any person who had an interest in the leased property at any time during the two-year period prior to the date the lease went into effect (or by a person related to such a person within the meaning of sec. 168(e)(4)(D)). Congress intended that a *de minimis* interest be ignored for this purpose.

A long-term agreement is a lease of property for a term in excess of 75 percent of the property's "statutory recovery period" (essentially, the recovery period provided under sec. 168 of the Code, relating to accelerated cost recovery). Property that is not recovery property is treated as if it were recovery property for this purpose.

A disqualified leaseback or long-term agreement is one that provides for no allocation of rents or has as one of its principal purposes the avoidance of taxes.

Tax avoidance purpose

General considerations

Congress intended that the determination of whether tax avoidance was a principal purpose of an agreement be made on the basis of all the relevant facts and circumstances. Significant factors in this determination are whether, and to what extent, the tax brackets of the lessor and the lessee differ at the time the lease is entered into, and the parties' reasonable expectations as to their relative tax brackets over the term of the lease. Congress believed that where the parties are in approximately the same marginal tax brackets (and reasonably expect to be so during the entire term of the lease), such that their aggregate tax liability will not be materially reduced by the stepping of rents, no tax avoidance motive generally should be found.[24]

However, where a lessor is in a significantly higher marginal tax bracket than a lessee—for example, where the lessee is a tax-exempt entity, has substantial NOLs, or is otherwise in a low marginal bracket—Congress believed that the motives of the parties in providing for stepped rents should be closely scrutinized. In these

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[24] *See* floor statement of Senator Dole, 130 Cong. Rec. S. 8409 (June 27, 1984). No significant reduction of the parties' combined taxes would occur, for example, if the lessors are a partnership composed of 50-percent-bracket individuals and the lessee is a 46-percent-bracket corporation; hence, this circumstance alone would not indicate a tax avoidance purpose. However, even where the parties are in substantially the same tax bracket, other circumstances might establish a tax avoidance purpose.

circumstances, taxpayers should be required to show that market conditions or other substantial business reasons justify the increases.

Under this analysis, the involvement of a tax-exempt organization, or of a taxpayer in an NOL position or low marginal bracket, would not create a conclusive presumption of a tax avoidance purpose, even where such person serves as a sublessor. Rather, all the facts and circumstances should be considered in determining the purpose of the transaction. If those facts and circumstances suggest substantial nontax reasons for the rent structure, the terms of the lease should be respected for tax purposes.

For example, if a tax-exempt trade association negotiates a long-term lease for office space in excess of its current needs in order to assure the availability of additional space in the future, and temporarily sublets a portion of the space to a taxable third party, the transaction need not be viewed as necessarily motivated by tax avoidance. Increases in rents under the primary lease and sublease will be respected if it is demonstrated that tax avoidance was not a principal purpose of the increases. The absence of such a purpose might be shown, for example, by the existence of leases containing similar terms between the primary lessor and taxable third parties. The burden of proving the absence of a tax avoidance purpose is on the taxpayer.

Another factor in determining whether a tax avoidance purpose exists is whether the lessee has an option to renew under the lease at a rental amount significantly less than rental amounts payable during the later years of the lease. This factor is particularly significant where the option rental amount is roughly equal to what the constant rental amount would have been for the primary term of the lease had the rent leveling provision been applicable.

Congress understood that the Treasury Department would issue regulations prescribing other factors that are indicative of a tax avoidance purpose.

Regulatory safe harbors

The Act directs the Treasury Department to prescribe regulations setting forth circumstances under which increases in rents will not be considered motivated by tax avoidance, including circumstances relating to increases in amounts determined by reference to price indices such as the Consumer Price Index, rents based on a percentage of the lessee's receipts or similar amounts, reasonable periods during which rents are forgiven or abated, and changes in amounts paid to unrelated third parties.

(*1*) *Price increases.*—Congress understood that under the Treasury regulations, a lease calling for rents that increase at a variable rate equal to the rate of the increase in the CPI (or other appropriate price index) during the lease period will not be regarded as having tax avoidance as a principal purpose. Furthermore, such a lease may limit the increase to a specified maximum percentage and still come within the CPI safe harbor. Any increases based on this type of formula may be aggregated and made in intervals of five years or less.

(*2*) *Percentage of receipts.*—Under Treasury regulations, increases based on a fixed percentage of the lessee's gross receipts or similar amounts will not be considered principally motivated by tax avoidance.

(3) *Rent holidays.*—The regulations will provide a safe harbor for rent increases attributable to so-called "rent holidays," that is, lease provisions under which no rent is payable (or is payable at a reduced rate) for a reasonable period of time after the commencement of the lease. Congress intended that the reasonableness of a rent holiday be determined by reference to commercial practice in the locality where the use of the property occurs at the time the lease is executed. Congress intended that a permissible rent holiday generally not exceed twelve months, and that in no event should it exceed twenty-four months.

(4) *Third party costs.*—Rent increases reflecting the lessee's obligation under the lease to bear specified costs of the lessor (such as real estate taxes, insurance, maintenance, and similar costs) will not be considered motivated by tax avoidance. Congress recognized that the amount of increases in third party costs (like increases in price indices) is generally not subject to manipulation by the parties.[25]

(5) *Percentage deviation from level rent.*—Congress understood that the Treasury Department will issue regulations adopting standards under which leases providing for fluctuations in rents paid by no more than a reasonable percentage above or below the average rent payable over the term of the lease will be deemed not motivated by tax avoidance. Congress recognized that the standards set forth in Rev. Proc. 75-21, wherein the Internal Revenue Service, for ruling purposes, accepted a 10-percent fluctuation above or below the average rent in the case of personal property leases, may be inappropriate for real estate leases. Accordingly, the regulations may provide less restrictive standards for such leases.

Constant rental amount

The amount of rent accrued by a lessor and a lessee under a disqualified leaseback or long-term agreement is the constant rental amount. This is the amount which, if paid as of the close of each lease period, would have a present value equal to the present value of the aggregate payments to be made under the lease. Present value for this purpose is determined using a discount rate equal to 110 percent of the applicable Federal rate, compounded semiannually.[26] Congress expected that the Treasury regulations would provide formulae that will facilitate the computation of this constant rental amount.

Recapture on disposition of leased property in certain situations

Where property subject to a long-term agreement or a leaseback is not subject to constant rental accrual (because the increases are

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[25] Congress intended no inference, however, as to the effect of a lease clause requiring the lessee to assume the burden of any increases in the lessor's debt service costs on the property (whether principal, interest, or both), including the effect of such a clause on the status of the lease as a true lease.

[26] For example, in the case of a lease calling for a lump-sum payment at the end of the lease term, the constant rental amount is that amount which, if paid on the last day of each lease year into a bank account bearing interest compounded semiannually at the applicable Federal rate, would produce an account balance at the end of the lease equal to the amount of the deferred payment.

not tax motivated), any gain realized by the lessor on a disposition of the property during the term of the agreement is treated as ordinary income to the extent of the "recapture amount." The realized gain is reduced by the amount of gain treated as ordinary income under other provisions of the Code (e.g., sec. 1245 or 1250) for purposes of this computation.

The recapture amount is the excess of (1) the amount which would have been taken into account by the lessor if the rents had been reported on a constant rental basis over (2) the amount actually taken into income by the lessor under the general accrual rule.[27]

The Act provides that, under regulations to be prescribed by the Treasury Department, exceptions similar to the exceptions provided under sections 1245 and 1250 shall apply for purposes of the rent recapture provision. Under these regulations, the ordinary income character of the gain inherent in the property will be preserved if the property is transferred and the transferee assumes the transferor's basis in the property.

Other regulations

General regulatory authority

The Act authorizes the Treasury Department to prescribe other regulations necessary to carry out the purposes of the provision, including regulations providing for the application of the provision where a lease involves contingent payments of rent.

Congress understood that, under these regulations, a lease will be exempt from section 467 (including the accrual reporting requirement, the rent leveling provision, and the recapture provision of that section) if it provides for reasonable increases in rent that are wholly contingent and cannot be reasonably ascertained at the time the lease is executed, provided all rents are payable by the end of the period to which they relate or become fixed, or within a reasonable time thereafter.[28]

Deferred payments for services

The Act directs the Treasury Department to issue regulations requiring that, in the case of deferred-payment transactions involving services, the interest element implicit in the transaction be taken into account on an accrual basis by the parties. Congress understood that, under its general regulatory authority, the Treasury Department will exempt from these regulations transactions to which section 404 or section 404A applies.

Decreasing payments of rent

The Act requires the Treasury Department to issue regulations governing the tax treatment of leases under which the rents are "front-loaded"—that is, in which rents decrease rather than increase over the term of the lease. Congress intended that the provisions relating to front-loaded rental agreements and the regula-

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[27] Congress intended that only amounts that are fixed and determinable at the time the lease is executed be taken into account in making this computation.

[28] Floor statement of Senator Dole, 130 Cong. Rec. S. 8884 (June 29, 1984).

tions thereunder be applied prospectively only, from the date of issuance of permanent or temporary regulations.

Effective Date

In general, these provisions are effective for agreements entered into after June 8, 1984. The Act provides certain transitional rules. First, the provisions do not apply to any lease entered into pursuant to a written agreement that was binding on June 8, 1984, and at all times thereafter.[29]

Second, the provisions do not apply to any lease if (1) on March 15, 1984, there was a firm plan, evidenced by a board of directors' resolution, memorandum of agreement, or letter of intent on March 15, 1984, to enter into the lease, and (2) construction of the property subject to the lease was commenced (but placement in service did not occur) on or before March 15, 1984. However, parties to any lease subject to this exception may in no event achieve a greater deferral or "backloading" of rents than provided in a statutorily prescribed schedule.[30] Thus, if the amount of rent allocable under a lease to a particular taxable year is less than the amount indicated by the schedule, the parties must report income according to the schedule. This limiting schedule does not apply (that is, the parties must report rents according to the actual terms of the lease) if the sum of the present values of all payments under the lease exceeds the sum of the present values of all payments deemed to be paid or received under the schedule.[31]

A third exception is provided for a specific transaction of a particular taxpayer-lessee in a sandwich lease transaction that had adopted a board of director's resolution on February 10, 1984, indicating an intent to enter into a sale-leaseback transaction.

Revenue Effect

The provisions are estimated to increase fiscal year budget receipts by $43 million in 1984, $258 million in 1985, $486 million in 1986, $654 million in 1987, $846 million in 1988, and $887 million in 1989.

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[29] An assignable lease or agreement to enter into a lease that was binding as to the original parties on June 8, 1984, is within the scope of this exception, even if assigned after June 8, 1984. *See* floor colloquy of Senators Dixon and Dole, 130 Cong. Rec. S. 8417 (June 27, 1984).

[30] *See* sec. 92(c)(2) and (c)(3) of the Act. The schedule divides the lease term into fifths and sets forth maximum cumulative percentages of total rents that may be deemed paid during each fifth. In applying this deemed rental schedule, the rent allocable to each taxable year within any fifth of the lease term is a level, pro rata amount.

[31] A discount factor of 12 percent is assumed for purposes of these computations.

6. Capitalization of Construction Period Interest and Taxes (sec. 93 of the Act and sec. 189 of the Code)[32]

Prior Law

Under present and prior law, no immediate deduction is allowed for real property construction period interest and taxes (Code sec. 189).[33] However, this rule did not apply under prior law to (1) low-income housing, (2) residential real property (other than low income housing) acquired, constructed or carried by a corporation (other than an S corporation, a personal holding company or a foreign personal holding company), or (3) real property acquired, constructed, or carried if such property is not, and cannot reasonably expected to be, held in a trade or business or in an activity conducted for profit. The capitalized interest and taxes are amortized generally over a 10-year period.

Prepaid interest must be capitalized and deducted in the year to which properly allocable under section 189(b). In addition, taxpayers may elect to capitalize certain taxes and interest attributable to both real and personal property and include the capitalized items in the basis of the property (Code sec. 266).

Reasons for Change

The allowance of a current deduction for construction period interest and taxes is contrary to the fundamental accounting principle that expenses incurred in improving or constructing property with an extended useful life should be capitalized as part of the cost of the property and recovered accordingly. In the case of a taxpayer who incurs interest and taxes in connection with the construction of a building, current law attempts, at least partially, to recognize this capitalization concept by requiring that interest and taxes incurred during the construction period be deducted over at least a 10-year period.

Under prior law, corporations were not required to capitalize construction period interest and taxes for residential real property. However, Congress believed that it was no longer appropriate to provide this exception since it was not compatible with the general objective of capitalizing the costs of construction of property with an extended useful life. In addition, individuals already are required to capitalize construction period interest and taxes on residential real property. While Congress believed that corporations should not be given more favorable treatment than individuals,

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[32] For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 72; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 280-281; and H. Rep. No. 98-861 (June 23, 1984), pp. 895-896 (Conference Report).

[33] For this purpose, real property includes certain property that is treated as personal property for purposes of the investment tax credit and depreciation.

Congress continued to believe that it is appropriate to continue to provide an exception from this rule for low income housing.

Explanation of Provision

The rules under section 189 are extended under the Act to require corporations to capitalize construction period interest and taxes for certain residential real property. As under prior law, this rule does not apply to low income housing (as defined in Code sec. 1250(a)(1)(B)(i), (ii), (iii), or (iv)) or real property acquired, constructed or carried if such property is not, and cannot reasonably be expected to be, held in a trade or business, or is an activity conducted for profit. The definition of construction period is the same as under prior law.

Effective Date

This provision applies to interest or taxes paid or incurred in taxable years beginning after December 31, 1984, for the construction of residential real property begun after March 15, 1984.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $159 million in 1985, $235 million in 1986, $217 million in 1987, $146 million in 1988, and $106 million in 1989.

7. Start-up Expenses (sec. 94 of the Act and sec. 195 of the Code)[34]

Prior Law

Under present and prior law, ordinary and necessary expenses paid or incurred in carrying on a trade or business, or engaging in a profit-seeking activity, are deductible (Code secs. 162 and 212). Expenditures made prior to the establishment of a business normally are not deductible currently since they are not incurred in carrying on a trade or business or while engaging in a profit-seeking activity.

Expenditures made in acquiring or creating an asset which has a useful life that extends beyond the taxable year normally must be capitalized (Code sec. 263 and Treas. Reg. sec. 1.461-1(a)(1)). These costs ordinarily may be recovered through depreciation or amortization deductions over the useful life of the asset, unless the costs relate to an asset with either an unlimited or indeterminate useful life, in which case costs may be recovered only upon disposition of the asset or the cessation of the activity to which such asset relates.

Under the rules of prior law, often it was unclear whether an expenditure could be deducted currently or should be capitalized. As a result, in 1980, Congress provided that a taxpayer may elect to treat start-up expenditures as deferred expenses which the taxpayer could deduct ratably over a period of not less than 60 months, as may be selected by the taxpayer (Code sec. 195). Start-up expenditures mean any amount paid or incurred in connection with (1) creating an *active* trade or business and (2) investigating the creation or acquisition of an *active* trade or business, which if paid or incurred in connection with the expansion of an existing trade or business would be allowable as a deduction in the year in which paid or incurred.

Reasons for Change

Despite the rules adopted in 1980, prior law was unclear whether a specific item should be capitalized, expensed, or amortized as provided in section 195. For example, some taxpayers who did not elect to amortize to start-up expenditures under section 195 argued that start-up expenditures were currently deductible as ordinary and necessary expenses under section 162 and, in any event, were deductible under section 212 as expenses paid or incurred in con-

[34] For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 73; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 282-283; and H. Rep. No. 98-861 (June 23, 1984), pp. 896-897 (Conference Report).

nection with property held for the production of income. The Internal Revenue Service disagrees with both these positions.[35]

Congress believed that start-up expenditures generally result in the creation of an asset which has a useful life which extends substantially beyond the year in which incurred. Therefore, such expenditures should not be fully deductible when paid or incurred but rather should be deducted over a longer term. In addition, Congress believed that prior law should be clarified to decrease the controversy and litigation arising under prior law with respect to the proper tax treatment of start-up expenditures. Accordingly, Congress believed that it was appropriate to require such expenses to be capitalized unless the taxpayer elects to amortize the start-up expenditures over a period of not less than 60 months.

In addition, Congress believed that the definition of start-up expenditures should be clarified to insure that the provision applies to expenditures made in anticipation of entering into a trade or business.

Explanation of Provision

The Act provides that a taxpayer generally is required to treat start-up expenditures as deferred expenses. As under prior law, a taxpayer may elect to amortize such expenses over a period selected by the taxpayer but not less than 60 months. If the trade or business is disposed of completely by the taxpayer before the end of such 60 month (or longer) period, such deferred expenses (to the extent not deducted under this section) may be deducted to the extent allowable under section 165.

Under the Act, the definition of start-up expenditures is generally the same as under prior law. However, the Act modified the definition in two respects. First, the definition of start-up expenditures is broadened to include any expenditures made with respect to any activity engaged in for profit or for the production of income before the day on which the active trade or business begins, in anticipation of such activity becoming an active trade or business. For example, Congress intended that the rent expenses permitted as a deduction in the *Hoopengarner* case will be subject to this provision. Likewise, Congress intended that expenses which were permitted as deductions in cases such as *Blitzer* v. *United States,* 684 F.2d 874 (Ct. Cl. 1982) and *Brotherman* v. *United States,* 6 Ct. Cl. 407 (1984) would be subject to the new provision. This change is effective for periods beginning after the June 30, 1984.

Second, the Act modified the requirement under prior law that start-up expenditures include any amount which, if paid or incurred in connection with the *expansion* of an existing trade or business, would be allowable as a deduction for the year in which paid or incurred. Under the Act, start-up expenses include such ex-

[35] The Tax Court has held that rental payments made pursuant to a leasehold interest in land on which the taxpayer was to construct and operate an office building are not deductible under sec. 162 for the period prior to completion of the building, since the taxpayer was not carrying on a trade or business at the time they were made. However, the court further held that a portion of the rental payments were deductible under sec. 212, since they were ordinary and necessary expenses paid or incurred for the management, conservation, or maintenance of property held for the production of income. *Herschel H. Hoopengarner* v. *Commissioner,* 80 T.C. 538 (1983); *Johnsen* v. *Commissioner,* 83 T.C. 103 (1984).

penses if paid or incurred in connection with the *operation* as well as the expansion of an existing trade or business.

Start-up expenditures that are allowed as deductions under sections 163(a), 164, and 174 are not treated as deferred expenses.

Effective Date

The provision applies to taxable years beginning after June 30, 1984.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $23 million in 1985, $36 million in 1986, $31 million in 1987, $26 million in 1988, and $19 million in 1989.

8. LIFO Conformity (sec. 95 of the Act and sec. 472 of the Code)[36]

Prior Law

Under present and prior law, generally a taxpayer may use the method of accounting for computing taxable income on the basis of which he regularly computes his income in keeping his books provided that such method clearly reflects income. However, if the production, purchase, or sale of merchandise is an income-producing factor, the taxpayer generally must take into account inventories at the beginning and end of each taxable year. Acceptable methods of accounting for inventories include specific identification, first-in first-out ("FIFO"), and last-in first-out ("LIFO"). However, under the so-called "LIFO conformity" rule, the LIFO method of inventory accounting may not be used for tax purposes unless it is also used in reporting to shareholders, partners, other proprietors, beneficiaries, or for credit purposes.

The Internal Revenue Service has issued several rulings, interpreting the LIFO conformity rule in a variety of factual situations. For example, some foreign parent companies with U.S. subsidiaries operate in countries which do not recognize the LIFO method as a proper method of accounting for financial reporting purposes. In Rev. Rul. 78-246, 1978-1 C.B. 146, the Service ruled that foreign parent corporations are permitted to convert the operating results of their subsidiaries using the LIFO method to a nonLIFO basis in consolidated financial statements under certain conditions without violating the LIFO conformity rule.

The IRS has also held that the LIFO conformity rule may be met even though there are differences in the book and tax statements which arise because the taxpayer adopted the LIFO method for financial statement purposes beginning with an accounting period other than the taxable year for which the taxpayer first used the LIFO method for tax purposes. (Treas. Reg. sec. 1.472-(2)(e)(1)(viii)(A).)

In *Insilco Corporation* v. *Commissioner*, 73 T.C. 589 (1980), *aff'd in an unreported decision* (2nd Cir. 1981), the Tax Court held that the LIFO conformity rule was met by a subsidiary using the LIFO method for Federal income tax purposes where the subsidiary used the LIFO method to compute its income in its financial reports issued to its parent company, even though the parent company converted the subsidiary's earnings to a nonLIFO basis in the parent's consolidated financial statements.

[36] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 163; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1380-1381; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 177; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 486-487; and H. Rep. No. 98-861 (June 23, 1984), pp. 897-898 (Conference Report).

Reasons for Change

The LIFO conformity rule is intended to ensure that taxpayers only use the LIFO method for tax purposes when it conforms as nearly as possible to the best accounting practice in the taxpayer's trade or business. Congress was concerned that taxpayers could avoid the effect of LIFO conformity rule under the *Insilco* decision through the creation of holding companies or subsidiaries. In addition, Congress was concerned that if a significant number of taxpayers were to take advantage of the *Insilco* decision, the revenue effect would be substantial. Accordingly, Congress believed that the LIFO conformity rule should be applied to all financial reports of all corporations in which the taxpayer's inventory is included. However, Congress believed that limited exceptions to the conformity requirement, as provided under prior law (or similar limited exceptions provided by the Treasury, if appropriate, in the future) should be allowed.

Explanation of Provision

The Act treats all members of the same group of financially related corporations as a single taxpayer for purposes of the LIFO conformity requirement. The term "group of financially related corporations" means (1) any affiliated group as defined in Code section 1504 (without regard to the exceptions in sec. 1504(b)) except that a 50-percent stock ownership test is substituted for the 80-percent stock ownership test and (2) any other group of corporations which issue consolidated or combined financial statements or reports generally to shareholders and others. Thus, the conformity requirement generally applies to a parent corporation (1) which issues financial statements to its shareholders on a consolidated basis with a subsidiary, or on a combined basis with an affiliated company, that uses the LIFO method of accounting for tax purposes or (2) which includes the results of operations under the equity method of financial accounting of a financially related corporation which uses the LIFO method of accounting for tax purposes, but only if that corporation is a member of the affiliated group by applying the 50-percent stock ownership test.

Under the Act, taxpayers who had relied on the *Insilco* decision will be required either to conform their financial statements to use LIFO for inventories of the affiliated corporations, or to change the inventories of the affiliated corporations to a nonLIFO method of accounting for tax purposes. A taxpayer who relied on the *Insilco* decision (or a similar interpretation of the law) in prior years may elect to remain on the LIFO method for tax purposes and conform its financial statements to the LIFO method to comply with the Act. In such a case, the LIFO cost for financial statement purposes may be different than the LIFO cost for tax purposes because the LIFO method is first used for financial reporting purposes in a different year than it was first used for tax purposes. Congress intended that such differences in the LIFO cost will not be treated as a violation of the conformity requirement (i.e., Treas. Reg. sec. 1.472-2(e)(1)(viii)(A) would apply).

Alternatively, a taxpayer who relied on the *Insilco* decision (or a similar interpretation of the law), may wish to adopt a nonLIFO method to comply with the Act. In such a case, Congress intended that such a taxpayer would be treated in the same manner as any taxpayer requesting a change from the LIFO method of accounting under present law (i.e., prior permission from the Internal Revenue Service must be obtained before there can be a change in accounting method and any adjustments required by the change in method of accounting would be treated generally as under present law). However, it is anticipated that taxpayers who request permission to change from the LIFO to a nonLIFO method for tax purposes to comply with the Act will be allowed a spread of any adjustment required under section 481 not to exceed 4 years.[37] Congress contemplated that the Treasury could provide rules allowing an automatic permission to change to a nonLIFO method for an appropriate transition period.

Under the Act, no inference is implied with respect to the taxpayer's compliance with the conformity requirement under prior law. Thus, even a taxpayer who complies with the provisions of the Act may nevertheless be subject to challenge by the Internal Revenue Service for violation of the conformity requirement in prior years. However, in order to prevent unwarranted exposure to subsequent decisions contrary to the *Insilco* decision, it is expected that, for this purpose, the IRS may provide a special procedure for taxpayers who wish to insure that they may use the LIFO method in future years to make a protective LIFO election (consistent in all respects with their existing LIFO election) so that taxable years beginning after the date of enactment are protected.[38]

The Act grants the Treasury Secretary the authority to provide by regulations exceptions to the provisions of the Act, including exceptions in situations described in Rev. Rul. 78-246, *supra.* Congress intended that taxpayers could continue to rely on existing rulings (e.g., Rev. Rul. 78-246) and regulations until new regulations are issued.

Effective Date

The provision applies to taxable years beginning after the date of enactment (July 18, 1984).

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $105 million in 1985, $185 million in 1986, $200 million in 1987, 1988, and 1989.

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[37] Rev. Proc. 80-51, 1980-1 C.B. 816 (as amended by Rev. Proc. 84-74, 1984-44 IRB 15) provides special rules for taxpayers who wish to change their method of accounting from a clearly erroneous method of accounting (a method of accounting that is specifically not permitted to be used by the taxpayer by the Code, regulations or a decision of the U.S. Supreme Court). For this purpose, the LIFO method as used prior to the effective date of this provision would not be treated as a clearly erroneous method because of reliance on the *Insilco* decision. (However, as under present law, if the taxpayer is found to have otherwise improperly used the LIFO method, no spread period will be allowed).

[38] No inference is intended as to whether a conditional LIFO election may be valid in other contexts. See T.D. 7976, Regs. sec. 5h.4 at (g).

H. Provisions Relating to Tax Straddles

(Secs. 101-108 of the Act, and secs. 263, 1091, 1092, 1234, 1234A, 1236, 1256, 1362, 1374, and 1402 of the Code)[1]

Prior Law

The Internal Revenue Code as amended by the Economic Recovery Tax Act of 1981, (ERTA) provides specific rules to prevent the use of straddles to defer income or to convert ordinary income and short-term capital gain to long-term capital gain. In general, the deduction of losses from straddle positions involving actively traded personal property (other than stock) is deferred except to the extent such losses exceed unrecognized gains on offsetting positions (sec. 1092). Gains and losses on regulated futures contracts ("RFCs") are reported under a mark-to-market rule that corresponds to the daily cash settlement system employed by U.S. commodity futures exchanges to determine margin requirements (sec. 1256).

Taxation of stock options

The straddle rules, including the loss-deferral rule, did not apply to stock or to domestic exchange-traded stock options under prior law (sec. 1092(d)). An option is considered an open transaction. The party that acquires property upon the exercise of an option to buy (a "call") or an option to sell (a "put") recognizes no gain or loss because the option and its exercise are, together, viewed as a purchase of the property. Both the holder of a call and the grantor of a put treats the premium paid or received as an adjustment to the purchase price of the underlying property. The party that sells the underlying property recognizes gain or loss. The holder of a put or the grantor of a call treats the premium paid or received as a reduction or increase of the amount realized on the sale of the underlying property.

Gain or loss from the sale or exchange of an option by an option holder is considered gain or loss from the sale or exchange of property that has the same character as the property to which the option relates has, or would have, in the hands of the holder (sec. 1234(a)). For purposes of applying this rule, if a loss is attributable to failure to exercise an option, the option is deemed to have been sold or exchanged. Thus, if the property to which the option relates would be a capital asset in the hands of the holder, capital gain or

[1] For legislative background of the provisions relating to straddles, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, secs. 101-105; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1262-1273; "Deficit Reduction Act of 1984" as approved by the Senate Committee on Finance on March 21, 1984, secs. 75-81; S. Rep. No. 98-169, Vol. II (April 2, 1984), pp. 284-297; H. Rep. No. 98-861 (June 22, 1984), pp. 898-917 (Conference Report); and H. Con. Res. 328, 130 Cong. Rec. S8944 (June 29, 1984), H7525 (June 29, 1984).

loss would result. The capital gain or loss would be long-term or short-term depending upon the holding period of the option. These rules apply to options to buy or sell property.

In the case of a grantor of an option, gain or loss from a closing transaction with respect to the option, or the lapse of the option, is treated as short-term gain or loss (sec. 1234(b)). Because the rules of sections 1234(a) and 1234(b) apply to options in property, it was unclear under prior law whether these rules apply to options that settle in (or could be settled in) cash. In addition, it was not clear whether gains and losses from transactions in cash settlement options are accorded capital gain or loss treatment under the rule (sec. 1234A) providing for such treatment on the termination of certain contracts.

Treatment of professional options traders

Historically, gain or loss from transactions in options granted or acquired in the ordinary course of a taxpayer's trade or business of granting options was treated as ordinary income or loss. In cases where a taxpayer grants or acquires options in the course of a trade or business and also holds options in connection with investment activities, the rules prescribed by section 1234 apply to the options granted or acquired as investments. Although, under prior law, the matter was not free from doubt, it appears that taxpayers who "make a market" with respect to a particular option were treated as granting or acquiring options in the course of a trade or business.

The short-sale rule

In the case of a "short sale" (i.e., where the taxpayer sells borrowed property and later closes the sale by buying identical property and returning the same to the lender), any gain or loss on the closing transaction is considered gain or loss from the sale or exchange of a capital asset if the property used to close the short sale is a capital asset in the hands of the taxpayer (sec. 1233(a)). The Code contains several rules designed to eliminate specific devices in which short sales could be used to transform short-term gains into long-term gains. Under these rules, if a taxpayer holds property for less than the long-term holding period and sells short substantially identical property, any gain upon the closing of the short sale is considered short-term gain, and the holding period of the substantially identical property is generally considered to begin on the date of the closing of the short sale (sec. 1233(b)). These rules prevent a taxpayer from "aging" his holding period so as to convert short-term capital gain into long-term capital gain where the taxpayer has materially reduced his risk of loss. Also, if a taxpayer has held property for more than the long-term holding period and sells short substantially identical property, any loss on the closing of the short sale is considered long-term capital loss (sec. 1233(d)). This rule is intended to prevent the conversion of long-term capital loss into short-term capital loss.

For purposes of these rules, property includes stock, securities, and commodity futures (sec. 1233(e)(2)(A)), but commodity futures contracts are not considered substantially identical if they call for delivery of the commodity in different calendar months (sec.

1233(e)(2)(B)). In addition, these rules do not apply in the case of hedging transactions in commodity futures (sec. 1233(g)).

For purposes of the short-sale rules, the acquisition of a put is treated as a short sale, and the exercise or failure to exercise such an option is considered as a closing of the short sale (sec. 1233(b)).

Application of wash-sale rule

The wash-sale rule disallows certain losses from the disposition of stock or securities where substantially identical stock or securities (or an option to acquire such property) are acquired by the taxpayer during the period beginning 30 days before the date of sale and ending 30 days after such date (sec. 1091). Commodity futures are not treated as stock or securities for purposes of this rule. Rev. Rul. 71-568, 1971-2 C.B. 312. Losses incurred in a trade or business were not disallowed by sec. 1091 under prior law except that, in the case of a corporate taxpayer, losses were disallowed other than those sustained in the ordinary course of business of a dealer in stocks or securities. The basis of the substantially identical stock or securities is adjusted to include the disallowed loss (sec. 1091(d)).

Loss deferral rule

If a taxpayer realizes a loss on the disposition of one or more positions in a straddle, the amount of the loss that can be deducted is limited to the excess of the loss over the unrecognized gain (if any) in offsetting positions. Positions are offsetting if there is a substantial diminution in the risk of loss from holding one position by reason of holding one or more other positions in personal property. Deferred losses are recognized in the first year in which there is no unrecognized gain in offsetting positions.

Exception for identified straddles

The loss-deferral rule does not apply to losses on positions in an identified straddle. To qualify as an identified straddle, all of the positions in the straddle must be acquired on the same day, the straddle must have all its positions closed on the same day or have no positions closed at the end of the taxable year, and the straddle must not be part of a larger straddle. An identified straddle must be clearly marked as such on the taxpayer's records before the close of the day on which it is acquired.

Losses on positions in an identified straddle are treated as sustained not earlier than the day on which the taxpayer disposes of all the positions comprising the straddle.

Hedging exemption

The loss-deferral rule does not apply to hedging transactions. A hedging transaction is a transaction that is executed in the normal course of a trade or business primarily to reduce certain risks, and that results in only ordinary income or loss. To prevent manipulation of the hedging exemption by tax-shelter syndicators, the exemption was made inapplicable to syndicates. A syndicate is defined as any partnership or other entity (other than a corporation that is not an S corporation), if more than 35 percent of the entity's losses during any period are allocable to limited partners or limited entrepreneurs. A hedging transaction must be clearly identified before the close of the day the transaction is entered into.

Treatment of mixed straddles

In general, a straddle composed of both RFCs and positions that are not RFCs is subject to the loss deferral rule, and the RFC positions of the straddle are subject to the mark-to-market rule. However, the RFC positions in a mixed straddle are excluded from the mark-to-market rule if the taxpayer designates the positions as a mixed straddle by the close of the day on which the first RFC included in the straddle is acquired. If a designated mixed straddle also qualifies as an identified straddle, the mixed straddle is exempt from the loss deferral rule.

Because the RFC positions and the non-RFC positions of a mixed straddle are taxed at different rates (and, possibly, at different times), a mixed straddle presents opportunities to defer tax and to convert long-term capital loss to short-term capital loss or short-term capital gain to long-term capital gain. However, under regulations authorized under prior law mixed straddles are subject to rules similar to the rules relating to short sales (described above), regardless of whether the straddle is designated as a mixed straddle or qualifies as an identified straddle (sec. 1092(b)). The statute contemplates that, under these rules, recognized losses will be recharacterized in appropriate cases.

Uncertainty in determining whether positions are included in or excluded from a particular straddle and the designation requirement applicable to mixed straddles limited the ability, under the regulatory authority of prior law, to develop rules effectively dealing with mixed straddles.

Capitalization of interest and carrying charges

Taxpayers are required to capitalize certain otherwise deductible expenditures for property that is held as part of an offsetting position, and for charges for the temporary use of property borrowed in connection with a short sale constituting part of a straddle (sec. 263(g)). Expenditures subject to this requirement ("carrying charges") are interest on indebtedness incurred or continued to purchase or carry property, as well as amounts paid or incurred for temporary use of the property in a short sale, or for insuring, storing or transporting the property. The amount of carrying charges required to be capitalized is reduced by any interest income from the property (including original issue and acquisition discount), which is includible in gross income for the taxable year. The capitalization requirement does not apply to hedging transactions (as defined above for purposes of the similar exemption from the loss-deferral rule).

Mark-to-market rule

Each RFC held by a taxpayer at year-end is treated as if it were sold for its fair market value on the last business day of the year (sec. 1256(a)(1)). Ordinarily, the settlement price determined by an exchange for its RFCs on the year's last business day is considered to be the RFC's fair market value. Any gain or loss on the RFC is taken into account for the taxable year, together with the gain or loss on other RFCs that were closed out before the end of the year. If a taxpayer holds RFCs at the beginning of a taxable year, any gain or loss subsequently realized on these contracts is adjusted to reflect any gain or loss taken into account with respect to the contracts in a prior year (sec. 1256(a)(2)). The mark-to-market rule is inapplicable to hedging transactions.

Historically, under case law, commodity futures traders have been treated as buying or selling capital assets (unless the taxpayers came within a nonstatutory hedging exemption). By statute, any gain or loss with respect to an RFC that is subject to the mark-to-market rule is treated as if 40 percent of the gain or loss is short-term capital gain or loss, and as if 60 percent is long-term gain or loss. This allocation of capital gain results in a maximum rate of tax of 32 percent for investors other than corporations.

Definition of an RFC

An RFC is a contract that (1) is marked to market under a daily cash settlement system of the type used by U.S. futures exchanges to determine the amount that must be deposited due to losses, or the amount that may be withdrawn in the case of gains, as the result of price changes with respect to the contract during the day, and (2) is traded on or subject to the rules of a domestic board of trade designated as a contract market by the Commodity Futures Trading Commission ("CFTC"), or any board of trade or exchange that Treasury determines to have rules that are adequate to insure compliance with the mark-to-market rules (sec. 1256(b)). Cash settlement futures contracts are included in the definition of an RFC.

Certain foreign currency contracts are treated as RFCs (sec. 1256(g)). For purposes of this rule, a foreign currency contract is defined as a contract that (1) requires delivery of a foreign currency that is also traded through RFCs, (2) is traded in the interbank market, and (3) is entered into at arm's length at a price determined by reference to the price in the interbank market.

Treatment of losses from pre-1981 straddles

Prior to the adoption of rules relating to straddles and marking RFCs to market by ERTA, it was unclear whether a claimed loss was allowable on the disposition of a position in a straddle where offsetting unrecognized gain on another position or positions included in the straddle was deferred. In Rev. Rul. 77-185, 1977-1 C.B. 48, the Internal Revenue Service ruled that a loss claimed on disposing of legs of a silver futures straddle where the straddle was continued was not deductible because there was no closed and completed transaction and the disposition represented no real economic change. Similar arguments were rejected by the Tax Court in *Smith* v. *Commissioner*, 78 T.C. 350 (1982), although the loss found to have been incurred in that case was disallowed because, under the facts of the case, it was not incurred in a transaction entered into for profit. The Internal Revenue Service has continued to litigate the allowability of pre-1981 straddle losses in accordance with the position adopted in Rev. Rul. 77-185 and has challenged such losses where claimed by commodity dealers as well as by investors with isolated transactions such as those involved in the *Smith* case.

Reasons for Change

Taxpayers have attempted to exploit the exemption from the loss-deferral rule for exchange-traded stock options to defer tax on income from unrelated transactions. If effective, these straddles in stock options defer gains from one year to the next by creating a recognized loss on an option that is matched by an unrecognized gain on an offsetting option. A typical abusive straddle involves the acquisition of "deep-in-the-money" offsetting option positions. (A call is in-the-money to the extent that the exercise price (or strike price) is less than the market value of the stock when the option is granted; a put is in-the-money to the extent the strike price exceeds the stock's value.) Regardless of whether the value of the underlying stock increases or decreases, one option position will result in a loss that can be realized for tax purposes, while the other position results in a gain of approximately equal size that can be deferred until the next year. The unrealized gain can be preserved by adopting a new offsetting position to replace the loss position that is disposed of. Although the Internal Revenue Service may be successful in challenging these transactions under rulings and case law, the law in this area applicable to transactions covered by prior law is unclear. The Congress believed that tax-motivated straddling in stock options is just as objectionable as the straddling in other actively traded property that occurred prior to enactment of the loss-deferral rule in ERTA.

One widely used investment strategy involves writing call options on stock owned by the taxpayer. The Congress believed that an exemption from the straddle rules should be provided for these transactions where they are undertaken primarily to enhance the taxpayer's investment return on the stock and not to reduce the taxpayer's risk of loss on the stock.

The Congress was also concerned about the disparity in the tax treatment of options market makers on securities exchanges and professional traders on commodity exchanges. Although the trading activities of these taxpayers are in some respects similar, under the case law, professional commodity traders were traditionally viewed as realizing capital gains or losses on futures transactions. In contrast, it appears that options market makers trading on securities exchanges were treated as realizing ordinary income or loss with respect to their options transactions. Moreover, an options dealer was considered to be a dealer in property subject to the option. As a result of the ordinary income or loss treatment that may have been available to options professionals, tax-shelter syndicates purporting to be market makers attempted to pass through ordinary losses on stock-option straddles to limited partners.

Another area of concern was that taxpayers might take inconsistent positions regarding the application of prior law to new investment products that were not traded when the tax straddle rules were enacted in 1981. For example, the treatment of exchange-traded options that settle only in cash was uncertain. Taxpayers with losses on cash-settlement options might claim ordinary loss treatment, while taxpayers with gains might claim capital gain treatment under the rules of prior law generally applicable to options. The Technical Corrections Act of 1982 revised the definition of RFCs to expressly include cash-settlement futures contracts. The Congress concluded that the status of cash-settlement options should be clarified. In addition, options on RFCs ("commodity options") are traded on domestic futures exchanges. Some taxpayers took the position that transactions in commodity options qualified under prior law for the 32-percent maximum rate of tax on gains provided by the statutory mark-to-market rule. (The Treasury Department disputed this interpretation of prior law.) However, taxpayers with losses might claim that, under prior law, they were subject to the general tax rules for options, and treat their losses as wholly short-term.

The question of the proper tax treatment of other new investment products raised a broader issue regarding whether competing investment products traded on different exchanges should be taxed under the same tax regime. For example, as noted above, some taxpayers were claiming that options on broad-based stock index futures were subject to the mark-to-market rules while direct options on broad-based indexes were subject to the general tax rules governing options. A related concern was the proliferation of mixed straddles between products that are subject to a 32-percent maximum rate of tax and products that are taxed at a 50-percent maximum rate. The Congress believed that the number of mixed straddles should be limited where possible.

The Congress determined that the regulatory authority granted to Treasury under prior law to prescribe rules for mixed straddles was not sufficient to insure the promulgation of rules that are effective.

The wash sale rule of prior law did not preclude the allowability of losses from short sales of stock in certain cases where the taxpayer closes a short sale and within a brief period before or after the closing, again sells substantially identical stock or sells the stock short.

For example, taxpayers may attempt to defer income by entering into a short sale of stock against the box (a short sale is referred to as being "against the box" if the seller holds stock that is identical to the stock sold short). If the value of the stock increases before the short sale is closed, the seller would acquire additional stock at the higher current price in order to close the short sale, generating a short-term capital loss. In this case, the rule that a short sale is deemed consummated on the date it is closed (Treasury reg. sec. 1.1233-1(a)(1)) would make the closing date the relevant date for applying the 61 day wash sale rule. The taxpayer could attempt to defer income by closing the short sale before year-end (offsetting unrelated income with the resulting short-term capital loss), and selling the retained stock after the beginning of the next taxable year. Even if the transactions occurred within a 30-day period, the prior law wash-sale rule would not apply if the stock held by the taxpayer was not acquired within the 30-day period preceding the close of the short sale. Thus, the taxpayer could take the position that the short-term capital loss is deductible, even though there is no economic loss (because the loss would be offset by an equal amount of unrealized gain in the stock). Alternatively, the taxpayer could replace the closed short position by entering into a new short sale after the beginning of the next taxable year, in order to claim a tax loss, essentially without terminating his position.

The Congress concluded that a more liberal exemption from the wash sale rule for individual investors who sustained securities losses in connection with a trade or business than that applicable to corporate taxpayers was not appropriate.

The hedging exemption, the mixed straddle election, and the identified straddle rule are subject to a requirement that the taxpayer identify the position or positions before the close of the day on which it is acquired. A similar identification requirement applies to securities dealers seeking capital asset treatment with respect to their securities holdings. The identified straddle rule also requires the identification to be made on the taxpayer's records. Because of the volatility of price movement in some positions, the "end of the day" identification requirement may not operate to preclude taxpayers from claiming beneficial treatment with respect to built-in losses or built-in gains resulting from price movement during the day, contrary to the purpose of such requirement.

The Congress concluded that it was inappropriate to prolong the uncertainty and attendant litigation as to claimed losses from straddle positions for periods prior to 1981.

Explanation of Provisions

1. Overview

The Act repeals the blanket exceptions from the straddle rules for exchange-traded stock options and certain other interests in stock. More limited exceptions are provided. In addition, the mark-to-market rule and the 32-percent maximum rate of tax are extended to certain exchange-traded options held by investors and to all listed options held by options market makers. Commodity options are also made subject to the mark-to-market rule and accorded the 32-percent maximum rate of tax. Positions subject to mark-to-market are renamed "section 1256 contracts".

2. Repeal of exception for certain stock and stock options

Exchange-traded stock options

In general, the straddle rules, including the loss deferral rule, are extended under the Act to straddles involving exchange-traded stock options. An exception is provided for a straddle the positions of which consist of stock and a qualified covered call option.

Stock

The Act extends the straddle rules to stock offset by an option with respect to such stock or substantially identical stock or securities, to stock of a corporation formed or availed of to take positions in personal property that offset positions held by any shareholder, and to stock that is part of a straddle one of the offsetting positions of which, under regulations, is a position with respect to substantially similar or related property (other than stock). All members of an affiliated group, as defined in section 1504(a), are to be treated as one taxpayer for purposes of applying the hedging exemption when a corporation is formed or availed of to take offsetting positions.

Application of the straddle rules to actively traded stock and exchange-traded stock options applies to positions established after December 31, 1983. However, the Congress intends that the regulations defining positions that are substantially similar or related to stock held by the taxpayer will apply to straddles described in the following paragraph only for positions established on or after March 1, 1984, and for positions not described in the following paragraph only on a prospective basis.

A straddle consisting of stock and substantially similar or related property includes offsetting positions consisting of stock and a convertible debenture of the same corporation where the price movements of the two positions are related. It also includes a short position in a stock index RFC (or alternatively an option on such an RFC or an option on the stock index) and stock in an investment company whose principal holdings mimic the performance of the stocks included in the stock index (or alternatively a portfolio of stocks whose performance mimics the performance of the stocks included in the index). Identical results will be applicable under the provision reducing the holding period of stock held by a corporation for purposes of the dividend received deduction where the taxpayer has diminished its risk of loss by holding another position in substantially similar or related property. However, stock offset by another position (other than an option) in substantially similar or related stock, which may result in a reduction in a corporate taxpayer's holding period for purposes of the dividend received deduction, does not constitute a straddle.

Qualified covered call options

A covered call option is one that is written with respect to stock that is held by the taxpayer (or acquired by the taxpayer in connection with the granting of the option). The granting of a covered call option does not substantially reduce a taxpayer's risk of loss with respect to the underlying stock unless the option is deep-in-the-money. The Act contemplates that taxpayers can continue to write at-the-money and non-deep-in-the-money covered calls, without running afoul of the straddle rules.

In general, a qualified covered call option is an exchange-traded option (1) the gain or loss with respect to which is not ordinary income or loss, (2) the term of which is more than 30 days, (3) which is not deep-in-the-money and (4) which is not granted by an options dealer in the ordinary course of his options writing activity. The term "deep-in-the-money option" is defined as an option that has a strike price lower than the lowest qualified benchmark. Generally, the "lowest qualified benchmark" is the highest available strike price that is less than the "applicable stock price" (defined below). In the case of an option with a term of more than 90 days and a strike price exceeding $50, the lowest qualified benchmark is the second highest available strike price that is less than the applicable stock price.

Exchange rules currently provide for strike prices on options at five-dollar intervals (or "benchmarks") for options on stock trading at prices under $100. For stock trading at prices over $100, there are $10 benchmarks. The lowest strike price currently authorized is $10. Thus, for example, with respect to stock trading at $50, an exchange-traded call option with a strike price of $45 or more would qualify for the exception.

The above rules are subject to the following limitations. First, if the applicable stock price is $25 or less, the lowest qualified benchmark is limited to 85 percent of the applicable stock price. Second, if the applicable stock price is $150 or less, the lowest qualified benchmark otherwise determined is limited to the amount which is $10 below the applicable stock price.

The term "applicable stock price" is generally defined as the closing price of the optioned stock on the most recent day on which such stock was traded before the date on which the option was granted. However, if the opening price of the optioned stock on the day the option is granted is greater than 110 percent of the closing price on the last previous trading date, then the opening price of the stock is treated as the applicable stock price.

In general, a qualified covered call option must be written on a national securities exchange registered with the Securities and Exchange Commission ("SEC"). The Secretary may designate other exchanges or markets qualifying for this treatment if the exchange or market has rules adequate to carry out the purposes of the exception to the straddle rules for qualified covered calls. The Act contemplates that, as a condition of designating an exchange or market, the Secretary could require that trades on the exchange or market be subject to information reporting under section 6045 (relating to reports by brokers).

The Secretary is granted broad regulatory authority to modify the provisions of the Act (e.g., to take account of changes in the practices of options exchanges or to prevent tax avoidance). The Congress contemplates that the Secretary will prescribe rules for the determination of the applicable strike price if the options exchanges modify their benchmarks.

For purposes of the loss deferral rule, but not for purposes of the limitations on interest and carrying costs (sec. 263(g)) and the short sale and wash sale rules in section 1092, a covered call option will not be treated as qualified if gain from the disposition of the stock to be purchased under such option is included in gross income in a taxable year subsequent to the year in which the option is closed and the stock is not held for more than 30 days following the date on which the option is closed. In determining whether this holding period requirement is satisfied, rules similar to those applicable in determining whether a taxpayer is eligible for the dividend received deduction under section 246(c)(3) and (4) will apply. Under those rules, the replacement of the terminated call position by the granting of a new qualified covered call will not cause a suspension of the 30-day holding period.

Under the Act, any loss realized from a qualified covered call option granted by the taxpayer which has a strike price below the applicable stock price will be long-term capital loss if gain from a sale or exchange of the stock at the time such loss is realized would be long-term. In addition, the holding period for the stock subject to such option will not include any period during which the taxpayer is the grantor of the option. It is anticipated that stock option losses and the holding period of stock will also be subject under regulations to section 1233(b) and (d) principles as applied to straddles consisting of stock and stock options. However, straddles consisting of stock and qualified covered call options to which the straddle rules are inapplicable will be affected only by the statutory rules under discussion. The tolling of the holding period of stock while the taxpayer is the grantor of a covered call option does not apply for purposes of section 851(b)(3), limiting the portion of the income of a regulated investment company that may be derived from the disposition of stocks and securities held for less than 3 months. No inference is intended that the lack of a specific statutory exclusion requires the application of section 1233 principles in applying section 851(b)(3).

3. Identified straddle rule

The Act extends the identified straddle rules of section 1092(a)(2) to straddles consisting entirely of section 1256 contracts. Thus, such a straddle which satisfies the definition of an identified straddle under section 1092 as amended by the Act will not cause section 263(g) or section 1092(a) to apply to any position by treatment of part or all of such straddle as also including positions not part of the identified straddle.

4. Transitional rule for hedging exemption

The identification requirement applicable to the hedging exemption does not apply to transactions in stock or stock options until September 16, 1984 (60 days after the date of enactment).

5. Extension of mark-to-market rule

The Act extends the mark-to-market rule (including the 60/40 treatment that results in a 32-percent maximum tax rate) to nonequity listed options and dealers' equity options. Rules are provided to prevent limited partners (or entrepreneurs) of an options dealer from recognizing gain or loss from equity options as 60 percent long-term capital gain or loss and 40 percent short-term capital gain or loss.

Definition of listed option contract

The Act defines a listed option as any option (other than a right to acquire stock from the issuer) that is traded on (or subject to the rules of) a qualified board of trade or exchange. A qualified board or exchange is a national securities exchange registered with the SEC, a domestic board of trade designated as a contract market by the Commodity Futures Trading Commission, or any other exchange, board of trade, or other market, that the Secretary determines has rules adequate to carry out the purposes of the relevant statutory provisions. The Act contemplates that, as a condition of designating an exchange, board of trade, or other market, the Secretary may require information reporting consistent with the rules of section 6045 (relating to returns of brokers).

Several stock index options are currently traded for which there has been no designation by the CFTC for futures trading in the same index. These options held by investors are not subject to mark-to-market and 60/40 treatment until the Secretary of the Treasury determines that they meet the requirements of law for such a CFTC designation. The Congress expects such designations will have prospective effect only. Thus, the Congress urges the Treasury Department to take prompt action to determine the status of these options. The Act provides for the extension of mark-to-market and 60/40 treatment, as well as the covered call exception, to options traded on a market other than a board of trade or exchange if the Secretary of the Treasury determines that such market has rules adequate to carry out the purposes of the provisions governing the treatment of section 1256 contracts. The Secretary is also to determine whether persons trading in such market qualify as options dealers.

Equity listed options

An equity option is defined to mean any option to buy or sell stock, and any other option the value of which is determined by reference to an index of stock of the type that is ineligible to be traded on a commodity futures exchange (e.g., an option contract on a sub-index based on the price of nine hotel-casino stocks). The definition of equity option excludes options on broad-based stock indexes (such as the Standard & Poor's 500 index) and options on stock index futures; thus, these options fall within the definition of nonequity options (discussed below). Holders of equity options (other than dealers) remain subject to the general rules for the taxation of options, including the loss-deferral rule.

Nonequity listed options

A nonequity option is defined as any listed option that is not an equity option. Under the Act, any holder of a nonequity option (whether an options dealer or an investor) is treated as if the option were disposed of at year-end for a price equal to its fair market value, and any gain or loss is taxed as if it were 60-percent long-term and 40-percent short-term (just as the holders of RFCs are treated). All options on RFCs are, by definition, nonequity options under the bill.

6. Treatment of dealer options

The Act changes the claimed present-law treatment of options market makers and codifies present law with respect to professional commodity traders by providing that both categories of traders are treated as buying and selling capital assets, except to the extent that an option or future is acquired to hedge property or obligations that would generate ordinary loss to the taxpayer (including property to be acquired or obligations to be incurred, to the extent the same result was obtained under prior law). An options dealer is defined as any person who is registered with an appropriate national securities exchange as a market maker or specialist in listed options. Under the Act, an options dealer will not recognize ordinary income or loss with respect to his stock and securities transactions, unless the taxpayer is a dealer in stock and securities under general Federal income tax rules (determined without regard to whether options in such property produce ordinary income or loss). Further, it is intended that the capital gain or loss status of options traded in the normal course of an option dealer's activity in trading options is to be determined without regard to the identification requirement of section 1236.

In addition to nonequity options, which are marked-to-market in the hands of all holders, equity options held by options dealers are also subject to the mark-to-market rule and 60/40 treatment. To prevent dealers from passing through 60/40 treatment of equity options to limited investors, the Act provides that 60/40 treatment does not apply to gain or loss on dealer equity options that is allocable to limited partners or limited entrepreneurs (regardless of the percentage of such gain or loss that is so allocated). Instead such gain or loss is treated as short-term capital gain or loss.

7. Treatment of gains and losses of options and commodities dealers as earned income and for certain subchapter S purposes

Under the Act, gains and losses derived in the ordinary course of trading in section 1256 contracts and property related to such contracts (e.g., stock used to hedge options) are defined as earnings from self-employment for purposes of applying the tax on self-employment income and the rules relating to contributions to self-employment plans. This treatment is extended only to options dealers, and commodity dealers, as defined in the Act. A commodity dealer is any person registered with a domestic board of trade designated as a contract market by the CFTC who buys or sells options or RFCs subject to the rules of such board. This treatment applies to taxable years beginning after the date of enactment except that for options dealers electing 60/40 and mark-to-market rules for the taxable year which includes the date of enactment, it applies for such taxable year. Commodity dealers may also elect such treatment for the taxable year which includes the date of enactment. No inference is intended as to whether options dealers and commodity dealers are to be viewed as engaged in a trade or business in connection with their transactions in section 1256 contracts as a result of the application of self-employment taxes to such persons.

A tax is imposed on corporations making a subchapter S election in certain cases where net capital gain exceeds 50 percent of the corporation's taxable income. Further, when an election is made by a corporation which has subchapter C earnings and profits, it may be taxable on a portion of its passive investment income and, in certain cases, the election may be terminated. To facilitate subchapter S elections by options and commodities dealers, the Act excepts gains and losses with respect to section 1256 contracts and related property derived in the normal course of an options or commodities dealer's transactions in options or commodities from net capital gain subject to to tax under section 1374 and from passive investment income as defined in section 1362(d)(3).

The Act provides that an election to be an S corporation made by a commodities dealer or options dealer within 75 days after the date of enactment of the Act (October 1, 1984) will be effective for the taxable year which includes the date of enactment, without regard to the requirement in section 1362(b) requiring the election to be made by the 15th day of the third month of the year. The Act provides that when this election is made, the taxpayer will be treated as having adopted a taxable year beginning on the first day during 1984 that it is a small business corporation as defined in section 1361(b) and ending on the date determined under section 1378. The Act also permits its extension of 60/40 and mark-to-market treatment to be applied at the taxpayer's election to positions held during the full taxable year which includes the date of enactment (sec. 102(g)(2)), and to pay any resulting increase in tax in 2 to 5 annual installments (sec. 102(h)). The S election, if it were interpreted to preclude the application of the full year election and installment payment of tax for any portion of the taxable year including the date of enactment (as determined without regard to the S election) would make those relief provisions unavailable to gains that qualify for such relief but for the S election.

It is intended that the elections under section 102(g)(2) and sec. 102(h) of the Act will apply to the taxable year determined without regard to the S election and will apply to a short taxable year ending before the date of enactment when such short year is created as a result of the S election, whether or not the electing corporation is a C corporation or an S corporation for such short year. It is also intended that an S election made pursuant to the Act wll apply (for the taxable year including the date of enactment as determined without regard to the election) commencing with the beginning of such year or, if later, the first day of the period which includes the date of enactment for which the corporation has been continuously a small business corporation, and ending with the date prescribed pursuant to section 1378. It is intended that such S taxable year may include a taxable year commencing in 1983 as well as one that terminates before the date of enactment as a result of the application of section 1378. The Treasury Department has adopted temporary regulations construing the S election as well as the section 102(g)(2) and section 102(h) elections to provide such rules, reg. sec. 18.1362-1(c) (49 Fed. Reg. 38920, October 1, 1984). It is intended that a technical corection will clarify and confirm that the S election produces these results.

8. Hedging exemption

In general, the hedging exemption under prior law remains available. However, the Act limits the ability of limited partners and limited entrepreneurs to deduct losses from hedging transactions against unrelated income where the hedging exemption is claimed.

Under the Act, an options dealer who is a dealer in the underlying property is treated the same as a commodity trader who is a dealer in the cash commodity. Thus, neither the loss-deferral rule nor the mark-to-market rule applies to an option or an RFC that is identified as a hedging transaction where gain or loss on both the option or the RFC and the underlying property would be ordinary income or loss (as determined under the Act).

For limited partners and limited enterpreneurs the Act limits the deductibility of any loss on a hedging transaction to the taxable income (determined without regard to such loss) derived from the conduct of the trade or business to which the hedging transaction relates. Taxable income as so determined is to be separately computed for partners and S corporation shareholders with such limited interests. The Congress intends that this rule be applied broadly so that, for example, a hedging loss sustained by a securities firm in its municipal bond operations may be deducted against profits from its other securities operations. However, limited partners may not deduct such losses against, for example, their dividend income. This provision is intended to prevent the passthrough of ordinary losses to limited investors from hedging transactions engaged in by traders who qualify as dealers in the underlying property.

The limitations on the deductibility of hedging losses allocable to limited partners and limited entrepreneurs apply to the following taxpayers: (1) any taxpayer who enters into a hedging transaction relating to stock or securities, (2) any individual, and (3) any corporation if at any time during the last half of the taxable year more than 50 percent in value of its outstanding stock is owned by five or fewer individuals. The term "hedging loss" is generally defined as the excess of (1) the allowable deductions for the taxable year attributable to hedging transactions (determined without regard to the rule limiting hedging losses), over (2) income received or accrued by the taxpayer during such taxable year from such transactions. However, an exception to the limitation on losses is provided for cases in which an overall economic loss occurs. The Act provides that the limitations do not apply to a hedging loss to the extent that the hedging loss for the year exceeds the aggregate unrecognized gains from hedging transactions (including gains from hedged property) as of the close of the taxable year. Hedging gains for this purpose include only those relating to the same trade or business in which the hedging losses were incurred. The "aggregate unrecognized gain" is defined as that term is used for purposes of the straddle rules: (1) the amount of gain that would be taken into account with respect to property if such property were sold on the last business day of such taxable year at fair market value, plus (2) in the case of any position with respect to which, as of the close of the taxable year, gain has been realized but not recognized, the amount of gain so realized.

9. Cash-settlement options

For cash-settlement options that are not subject to the mark-to-market rule (e.g., narrow-based options on sub-indexes of stock), the Act amends section 1234 to clarify that gain or loss on the sale, exchange, lapse, or exercise of the option is capital gain or loss with respect to grantors or holders. For purposes of the Act, a cash-settlement option is defined as any option which on exercise settles in (or could be settled in) cash or property other than the underlying property. As under prior law, the receipt of cash on exercise of a cash-settlement option is a taxable event.

10. Options on section 1256 contracts

The Act provides that gain or loss is recognized on the exercise of an option on a section 1256 contract. Under this provision, if an option on a section 1256 contract is excluded from mark-to-market and 60/40 treatment as a result of a mixed straddle election, the treatment of gain or loss resulting from exercise of the option will be determined under the rules of section 1234(a) and (b). Under these rules, options holders will have long-term or short-term gain or loss, depending on their holding period for the option and grantors will have short-term gain or loss.

11. Capitalization of interest and carrying costs

Interest and carrying costs of a straddle position that are required to be capitalized are reduced, under the Act, by dividends on stock included in a straddle. The reduction is limited to the portion of the dividend included in income after allowance of the dividends received deduction. The Act also provides for additional reductions with respect to market discount and acquisition discount included in income under sections 1276 and 1281 as added by the Act. New section 263(h) added by the Act, which disallows the deduction of short sale expenses in certain cases, section 1277 added by the Act, which requires the deferral of net direct interest on indebtedness with respect to market discount bonds, and section 1282 as added by the Act, which requires the deferral of interest on indebtedness with respect to short-term obligations, are to be applied before the application of the rule requiring the capitalization of costs with respect to straddle positions.

12. Technical amendment clarifying the treatment of market discount on residential mortgage securities

Section 1234A provides that gain or loss from the cancellation, lapse, expiration, or other termination of a right or obligation with respect to personal property is treated as capital gain or loss. Property subject to this rule is any personal property of a type that is actively traded and that is (or would be on acquisition) a capital asset in the hands of the taxpayer.

Section 1234A was enacted in 1981 to prevent certain straddles abuses,[2] and was not intended to change the long-standing tax treatment of market discount on residential mortgage investments and other obligations of natural persons as ordinary income. See section 1271(b). The amendment (sec. 102(e)(9) of the Act) merely clarifies that the same result is obtained when the holder's interest is an indirect one, such as a security in a fixed investment trust investing in residential mortgage.

13. Mixed straddle regulations

The Act extends the regulatory authority, with respect to mixed straddles, to include as a mixed straddle positions not described as such in present law section 1256(d)(4). In addition the regulatory authority is extended to provide rules governing the capitalization of interest and carrying costs with respect to straddle positions (sec. 263(g)).

In addition, the Act prescribes that the regulations will provide rules that will apply in lieu of the application of section 1233(d)

[2] See, for example, the description of a transaction involving offsetting positions in foreign currency. S. Rep. No. 97-144 (July 6, 1981), p. 171.

principles to mixed straddles if the taxpayer so elects. Under these rules, a taxpayer may either (1) offset gains and losses from positions which are part of mixed straddles by separately identifying each mixed straddle to which such treatment applies or (2) establish a mixed straddle account with respect to a class of activities for which gains and losses will be recognized and offset on a periodic basis. These two new elections will be in addition to the mixed straddle election of present law. Under either of the new alternatives, 60/40 treatment will apply only to net gain or loss from the straddle transactions and only to the extent attributable to section 1256 contracts. Under the rules applicable to a mixed straddle account, not more than 50 percent of any net gain may be treated as long-term capital gain and not more than 40 percent of any net loss may be treated as short-term capital loss.

It is intended that regulations adopting the principles of section 1233(d), authorized under prior law for straddles, will result in recharacterizing short-term losses realized from mixed straddle positions not subject to section 1256 as 60/40 losses in the case of mixed straddles that are not either identified or subject to the account described in the preceding paragraph. A mixed straddle may also produce 60/40 losses on the section 1256 contracts and short-term gain on the other positions included in the mixed straddle, effectively converting long-term gain realized from transactions unrelated to the straddle to short-term. Taxpayers can avoid this result by making a mixed straddle election foregoing marking-to-market and 60/40 treatment for their section 1256 contracts included in a mixed straddle.

The regulations prescribed by the Act will permit taxpayers to avoid the loss recharacterization rule that results from applying section 1233(d) principles while retaining favorable treatment for mixed straddle net gains derived from section 1256 contracts.

Straddle-by-straddle identification

It is intended that, in applying the regulations to separately identified mixed straddles, the determination by the taxpayer of what constitutes a mixed straddle generally will be accepted by the Internal Revenue Service if the taxpayer has adopted a reasonable and consistently applied method of identifying straddle positions which clearly reflects income in the absence of circumstances indicating that the taxpayer has not properly identified straddles pursuant to such method.

The present law election to exclude section 1256 contracts from 60/40 and mark-to-market treatment may be exercised only if all positions included in a mixed straddle are identified not later than the day on which the first section 1256 contract so included is acquired. It is intended that the offset for gains and losses from mixed straddles under the regulations may apply in cases where the taxpayer holds either section 1256 contracts or other positions before a mixed straddle is established. In such cases it is intended that the regulations will require the pre-straddle gains and losses accrued at the time the mixed straddle is created to be recognized at such time. Such gain or loss from positions not subject to sec. 1256 will be short-term or long-term, depending on the taxpayer's holding period when the mixed straddle is created, and gain or loss from pre-existing section 1256 contracts will receive 60/40 treatment. In all such cases, appropriate basis adjustments will be made to exclude such pre-existing gains and losses from the mixed straddle offsetting rules.

If a mixed straddle is terminated without disposing of all positions, it is contemplated that the regulations will require recharacterization of gains and losses from some closed positions. Such recharacterization will involve recharacterizing 60/40 gains and losses as short-term rather than *vice versa*. For example, if the taxpayer closes a section 1256 contract at a loss of $10 which is offset by an unrealized gain of $10 on an offsetting position not subject to section 1256, the loss will be recharacterized as short-term and will be deferred under section 1092 to the extent there continues to be unrecognized gain on the offsetting position at year-end. Under the offsetting position rules, if the loss on the section 1256 contract in this example were $12, the additional $2 that is not offset by unrealized gain would receive 60/40 treatment and would be recognized, assuming it is not offset by unrecognized gain in the offsetting position at year-end. Similarly, if the taxpayer realized a $12 gain on closing a section 1256 contract offset by an unrealized $10 loss on an open offsetting position not subject to section 1256, the rule would recharacterize $10 of such gain as short-term, which would be recognized currently since section 1092 does not defer gains. The remaining gain of $2 would also be recognized and receive 60/40 treatment. The taxpayer could avoid tax on the $10 gain converted to short-term by closing out the offsetting position at a $10 loss before year-end.

If a mixed straddle is terminated by closing out positions other than the section 1256 contracts, it is contemplated that the gain or loss will be offset by the loss or gain with respect to the section 1256 contracts as of the time such positions are closed and any net gain or loss attributable to the positions other than section 1256 contracts will be short-term. Losses from closing positions other than section 1256 contracts generally will not be deferred by sec. 1092 but instead will be netted against any offsetting gain on the section 1256 contracts included in the mixed straddle to the extent of such gain at the time the loss position is terminated. Adjustments to subsequent gain or loss with respect to section 1256 contracts included in a mixed straddle and retained following its termination will be made as under section 1256(a)(2) to reflect the portion of such gain or loss absorbed under the offsetting position rules. For example, if the taxpayer closes a position other than a section 1256 contract at a $12 gain and, on the date of disposition, there is a $10 loss determined by marking-to-market the offsetting section 1256 contract, the taxpayer will have a $2 short-term gain. If the taxpayer retains the section 1256 contract at year-end and it is marked-to-market at the same price that resulted in the offsetting $10 loss, no further gain or loss is recognized.

The holding period of positions other than section 1256 contracts included in a mixed straddle will not commence until the mixed straddle is terminated. In this regard, all post-straddle period gain or loss, as to amount and treatment as short-term or long term, is to be determined without regard to gain and loss attributable to the straddle period.

For mixed straddles with respect to which both section 1256 contracts and offsetting positions remain open at year-end, gain and loss attributable to positions that are not section 1256 contracts are not recognized currently. However, gains on section 1256 contracts are recognized under section 1256 and, to the extent offset by unrecognized losses on positions that are not section 1256 contracts, will be recharacterized as short-term gains under the regulations. Similarly, year-end losses on open section 1256 contracts, to the extent offset by unrecognized gains on positions that are not section 1256 contracts, will be recharacterized as short-term losses and will be deferred under section 1092.

Mixed straddle account election

The mixed straddle account rules will accommodate taxpayers who, with respect to a class of trading activities, have such a large volume of transactions that identification of specific mixed straddles is impractical. The account rules will accommodate, for example, market makers in options on XYZ company stock who also have long and short non-option positions in XYZ company stock in substantial volume. If the taxpayer is also a market maker in options on ABC company stock, it is intended that a second account be established with respect to such options and the underlying stock. It is intended that the Treasury have considerable flexibility in determining the nature of these accounts, and in specifying the classes of activities for which separate accounts must be established.

All gains and losses on positions in the account are to be determined and offset on a periodic basis which may be a daily or less frequent basis. Those positions not closed during the period are to be marked-to-market as of the close of the period and adjusted (as to both options and non-option positions) in the manner described in sec. 1256(a)(2) in order to avoid duplicating gain or loss on positions carried into the subsequent period. In determining how frequently positions in the account are to be marked-to-market and gains and losses are to be netted, the Secretary is to take account of recordkeeping and other administrative burdens that would be imposed on taxpayers.

Gains and losses from positions that are not section 1256 contracts are to be netted for the period and gains and losses from section 1256 contracts for the period are separately netted. The gain or loss from the positions that are not section 1256 contracts are then offset against the loss or gain from the section 1256 contracts. Overall net gain or loss for the period attributable to positions not subject to section 1256 constitutes short-term gain or loss. Overall net gain or loss for the period attributable to section 1256 contracts constitutes 60/40 gain or loss. The account net short-term gain or loss and the account net long-term gain or loss for the taxable year is to be determined by netting the aggregate gains and losses for the separate periods as so determined before any account gains or losses are applied against losses and gains from non-account sources. If, as a result of applying these rules, over 50 percent in the aggregate of the account net gain for the taxable year is long-term, the excess over 50 percent will be converted to short-term gain. Similarly, if over 40 percent in the aggregate of the account net loss for the taxable year is short-term, the excess over 40 percent will be recharacterized as long-term loss.

For example, assume that A, a market maker in stock options, has elected to adopt an account with respect to his market-making activities in XYZ corporation stock and (for illustrative purposes only) that mark-to-market accounting is required as of the close of each quarter so that the taxable year consists of four periods for which separate netting of section 1256 contracts (in this case, options) and non-section 1256 contracts (in this case, stock) is required with respect to A's positions in XYZ corporation stock. For the first quarter, A's gains from stock positions exceed losses by $5,000, and option losses exceed option gains by $6,000. The second quarter activity results in a net stock loss of $7,000 and net option gain of $8,000; the third quarter results in net stock gain of $1,000 and net option gain of $2,000; and the fourth quarter results in net stock loss of $2,000 and net option gain of $7,000. The taxable year result is tabulated as follows:

Period	Stock positions	Option positions	Net	Treatment	Net for period	
					Long term	Short term
1	$5,000	($6,000)	($1,000)	60/40	($600)	($400)
2	($7,000)	$8,000	$1,000	60/40	600	400
3	$1,000	$2,000	$3,000	[1] $1,000		
				[2] $2,000	1,200	1,800
4	($2,000)	$7,000	$5,000	60/40	$3,000	2,000
Culmulative result for all periods					$4,200	$3,800
Limitation (only 50 percent of account net gain may be long-term)					$4,000	$4,000

[1] Short term.
[2] 60/40.

If, in the above example, the results for periods 1 and 2 were the same but for period three, there was an excess of option net gain over net loss from stock positions of $1,000 and for the fourth period there was an excess of stock net loss over option net gain of $5,000, the result would be $600 of net long-term gain and $400 of net short-term gain for period three and a net short-term loss of $5,000 for period four. The cumulative result (periods one and two in the aggregate resulting in no net gain or loss) would be a $600 net long-term capital gain and a $4,600 net short-term capital loss. Without regard to characterization the account results in a net loss of $4,000 for the taxable year, only 40 percent of which may be characterized as short-term. As a result, only $1,600 of A's losses from the account may be treated as short-term in applying such losses against gains derived from transactions outside the account.

Gains and losses with respect to positions entering the account that have accrued as of the date the account is established will be recognized at that time and treated as long-term or short-term depending on the taxpayer's holding period as of that date, or as 60/40 gain or loss for section 1256 contracts. Appropriate basis adjustments will be made to reflect such gains and losses. Similar rules will apply where positions are transferred to and from the account.

It is intended that, under the regulatory rules prescribed by the Act, the Treasury will have broad authority to place positions held by the taxpayer in the account and to exclude positions from the account, and otherwise to prescribe standards with respect to the account to insure that income is clearly reflected, and the purpose of the mixed straddle rules is carried out.

Effective date of regulations

The Act precludes application of the regulations under section 1092(b) applying sec. 1233 principles to mixed straddles established prior to January 1, 1984. The Act requires that the initial regulations under section 1092(b) (including regulations relating to mixed straddles) are to be prescribed within 6 months after the date of enactment (i.e., by January 18, 1985). It is intended that the regulations providing for netting of identified mixed straddles and for a mixed straddle account will apply to any taxable year, if the taxpayer elects, to the extent that the amendments applicable to section 1256 contracts under the Act apply for such taxable year under the effective date provisions of section 102(f) and (g) of the Act.

14. Wash sale rules to apply to losses on certain short sales and other transactions

The Act extends the wash sale rule to a loss realized on the closing of a short sale if, within 30 days before or after such closing, the taxpayer sells, or enters into another short sale of, substantially identical stock or securities.

Under prior law, the wash sale rule did not apply, in the case of taxpayers other than corporations, if the loss was incurred in a trade or business while, in the case of a corporation, it was inapplicable only if the taxpayer was a dealer in stocks or securities and the loss was sustained in a transaction made in the ordinary course of such business. Thus, the wash sale rule did not apply to noncorporate taxpayers who were in a trade or business of trading in stocks or securities. Under the Act, the wash sale rule is inapplicable only if the taxpayer is a dealer in stocks or securities and the loss is sustained in a transaction made in the ordinary course of the taxpayer's business of dealing in stocks and securities. Thus, the exemption applicable to noncorporate traders has been terminated.

15. Time for identification by taxpayers of certain transactions

The Treasury is authorized under the Act to impose earlier identification deadlines under certain provisions requiring identification of a position by the close of the day on which the position is acquired. This requirement is to be imposed by regulation and applies to the hedging exemption, the mixed straddle election, identified straddles, and, in the case of securities dealers, the identification of securities held for investment. It is contemplated that any additional identification requirements for the hedging exemption that may be imposed under the regulations will be consistent with the intended application of the identification rule for the hedging exemption expressed in the report of the Senate Finance Committee in 1981 as follows:

> Taxpayers, such as banks or securities dealers, who may conduct thousands of hedging transactions to hedge property held or to be held in their accounts, may identify such accounts as hedged accounts without marking individual items as hedges or hedged property, provided such accounts deal only with ordinary income (or loss) items. S. Rept. No. 144, 97th Cong., 1st Sess. 151 (1981).

Treasury would have the authority to require earlier identification only for particular classes of taxpayers, like tax shelters, or to exempt particular classes of taxpayers, like bona fide government securities dealers.

16. Treatment of losses from pre-1981 straddles

The Act provides that a loss on the disposition of a position entered into before 1982 will be allowed, except to the extent nonrecognition is required under any applicable provision, if the position is part of a transaction entered into for profit. This treatment applies where the position is part of a straddle as defined in section 1092 as in effect on the day after the date of enactment of ERTA (as well as a straddle consisting entirely of RFCs), and is one to which the provisions of Title V of ERTA did not apply. The loss generally will be allowed for the taxable year in which the position is disposed of. Rules affecting the period within which the loss is recognized, and its treatment as long-term or short-term, other than section 1233 or section 1234, are to be applied without regard to the fact that the position is part of a straddle.

In determining whether a 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.

In the case of commodity dealers and persons actively engaged in investing in RFCs, the provision is to be applied by presuming that the position is held as part of a transaction entered into for profit unless the Internal Revenue Service establishes to the contrary. The presumption does not apply to a syndicate, as defined in section 1256(e)(3)(B). In determining whether a taxpayer is actively engaged in trading in RFCs with an intent to make a profit, a significant factor will be the extent of transaction costs. If they are sufficiently high relatively to the scope of the taxpayer's activities that there is no reasonable possibility of a profit, the presumption will be unavailable. RFCs for purposes of applying the presumption are regulated futures contracts as defined in section 1256(b) before its amendment by the Act.

For purposes of the provision, the term "commodities dealer" has the same meaning as such term in the amendments by the Act providing for application of the self-employment income tax to such persons.

Effective Dates

General rules

In general, the provision repealing the exemption from the straddle rules for stock options and certain stock applies to positions established after December 31, 1983. The identification requirement under the hedging exemption will not apply with respect to stock and stock options acquired or entered into within 60 days after the date of enactment. However, the application of the straddle rules to offsetting position stock is effective for positions established on or after May 23, 1983. The rule characterizing certain qualified covered call losses as long-term and suspending the holding period of stock for the period the taxpayer is the grantor of such options applies to positions established after June 30, 1984. The extension of the identified straddle rule to straddles consisting entirely of section 1256 contracts applies to positions established after the date of enactment.

The provisions extending the mark-to-market rule to nonequity options and dealer equity options generally apply to positions established after the date of enactment. However, with respect to commodity options, the amendments made by the bill apply to positions established after October 31, 1983.

The provisions clarifying the treatment of cash-settlement options and requiring recognition of gain or loss on exercise of commodity options apply to options purchased or acquired after October 31, 1983. The amendments to the hedging exemption apply to taxable years beginning after December 31, 1984. The amendments relating to the time for identification of certain transactions apply to items identified after the date of enactment.

The application of the wash sale rules to certain short sales applies in the case of short sales entered into after the date of enactment. The limitation of the exemption from the wash sale rule to losses sustained in the ordinary course of the taxpayer's business as a dealer in stocks or securities applies to sales after December 31, 1984.

Elections

The mark-to-market rules may be applied to nonequity options and dealer equity options on or before the general effective dates under either of two elections provided by the Act.

Positions held on the date of enactment.—Taxpayers can elect to apply the mark-to-market rule to nonequity options or dealer options that they held on the date of enactment. The election must cover all such positions held by the taxpayer on the date of enactment.

Positions held on or before the date of enactment.—In lieu of the election described above, taxpayers can elect to apply the mark-to-market rule to all positions held by the taxpayer during the taxable year that includes the date of enactment (the "transition year"). If the taxpayer makes this full-year election, all nonequity listed options and dealer equity options held at any time during the transition year must be marked-to-market.

With respect to stock options and stock that is ordinary income or loss property (to the extent offset by such options), any tax liability for the transition year which is attributable to appreciation in such options and such stock can be paid in two to five equal annual installments. This election applies with respect to gain from stock and options which would be ordinary income if the stock and options were disposed of by the taxpayer on the last day of the taxable year preceding the taxable year which includes the date of enactment. Interest is charged on any unpaid installments of tax that are still outstanding after the due date for the first installment.

Revenue Effect

The provisions relating to straddles are estimated to increase fiscal year budget receipts by $22 million in 1984, $427 million in 1985, $152 million in 1986, $70 million in 1987, $58 million in 1988, and $45 million in 1989.

I. Depreciation and Related Provisions

1. Depreciation of Real Property (sec. 111 of the Act and sec. 168 of the Code)[1]

Prior Law

Generally, real property placed in service by the taxpayer after 1980, and qualifying as recovery property, could be depreciated on an accelerated basis under ACRS over a 15-year period, under tables of recovery percentages prescribed by the Secretary. Under those tables, which were to reflect the number of months in the taxable year during which the taxpayer had the property in service, real property placed in service (or disposed of) by a taxpayer at any time during a month was treated as having been placed in service (or disposed of) by the taxpayer at the beginning of that month. Taxpayers generally were given an election, under section 168(a)(3), to depreciate real property qualifying as recovery property on a straight-line method over 15, 35, or 45 years. Certain real property (e.g., real property owned at any time during 1980, by a person related to the taxpayer) placed in service by the taxpayer after 1980, does not qualify as recovery property under section 168(e)(4)(B).

In general, components of a building which are section 1250 class property are depreciated by the taxpayer in the same manner as the building itself.

Generally, a transferee of real property qualifying as recovery property may elect a recovery period or method different from that elected by the transferor. However, restrictions were imposed by section 168(f)(10) to prevent the use of certain kinds of asset transfers as a mechanism to change the recovery period or method for the property involved. For transfers subject to these restrictions, the transferee had to "step into the shoes" of the transferor with respect to the recovery period and method for the transferred property. This rule applied only to the extent that the basis of the property in the transferee's hands did not exceed the transferor's adjusted basis in it. The transferee could elect to depreciate any excess pursuant to any recovery period and method available under the general rules.

Asset transfers subject to the rule of the preceding paragraph included sale-leasebacks (sec. 168(f)(10)(B)(iii)), transfers between certain related persons (sec. 168(f)(10)(B)(ii)), and tax-free asset trans-

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[1] For legislative background of the provisions, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 171; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 460-464; Senate floor amendment, 130 Cong. Rec. S. 4530-4536 (April 12, 1984); H. Rep. No. 98-861 (June 23, 1984), pp. 1005-1007 (Conference Report); H. Con. Res. 328, 130 Cong. Rec. H. 7128, 7129, and 7130 (June 27, 1984); and H. Con. Res. 328, 130 Cong. Rec. H. 7525, 7529, and 7530.

fers described in sections 332 (other than a transaction to which section 334(b)(2) applies[2]), 351, 361, 371(a), 374(a), 721, or 731 (sec. 168(f)(10)(B)(i)).

Reasons for Change

The Congress believed that reducing the rate at which depreciation deductions are allowed with respect to 15-year real property would reduce the tax revenue cost associated with tax-motivated real estate shelters, "depreciation-strips", and similar transactions without harming incentives for capital formation in productive investments. Similarly, the Congress believed that a slow-down of allowable depreciation deductions would reduce the economic inefficiency and tax revenue cost associated with purely tax-motivated transactions, reduce overbuilding, improve the allocation of capital, and make it less likely that investors would be able to combine tax benefits to achieve negative effective tax rates (i.e., subsidies) on debt-financed real property.

Prior to the Economic Recovery Tax Act of 1981 (ERTA), real property could generally be depreciated on a component-by-component basis over a period based on the estimated economic useful life of each component to the taxpayer. The average depreciation period for real property was over 30 years. ERTA reduced the minimum depreciation period for most real property, and components, to 15 years—less than one-half the average estimated economic useful life of real property under pre-ERTA law.

It was the Congress' view that this generous depreciation for real property contributed to a rapid growth in tax-oriented real estate partnerships. Statistics of Income data show that one-third of all partnerships filing returns in 1981 were primarily engaged in real estate transactions. Of these 522,000 real estate partnerships, 59 percent reported no taxable income. Instead they claimed tax losses of $17.8 billion.

The Congress also believed that ERTA's reduction in the depreciation period for real property resulted in a growing number of sale-leaseback transactions involving corporate headquarters, hotels, retail stores, and other types of real property new to the seller-lessee. In those transactions, taxpayers with insufficient taxable income to utilize accelerated depreciation deductions on buildings new to them sold their buildings to tax-shelter partnerships and leased them back. Such a transaction was known as a "depreciation strip" since the selling taxpayer frequently guaranteed to lease the property and pay all operating costs on a long term basis. In effect, such a transaction, assuming it qualified as a lease for Federal income tax purposes, left the purchaser with little interest in the property other than the right to claim depreciation deductions.

The Congress also understood that the liberalization of the depreciation rules in 1981 encouraged pre-1981 owners, who were required to use the old depreciation rules, to sell their property to new investors and to acquire other property. It was apparent that

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[2] A similar exception applied in the case of a transaction as to which an election under section 338 was made or deemed made.

these and similar transactions had a large tax revenue cost and did not increase capital formation or economic growth.

In addition to the liberal depreciation rules, real property benefits from other special provisions of the Code. Real property is exempt from the "at-risk" rules, which permit deduction of interest payments and depreciation only to the extent that the investor is at-risk. This exemption is especially valuable in tax-shelter real estate investments, which are often heavily financed with non-recourse debt. Real property also benefits from special recapture rules. If the straight-line method of depreciation was used, generally none of the gain on resale is recaptured (i.e., subject to tax as ordinary income). For certain residential property, more favorable rules require only partial recapture for property depreciated under an accelerated method. Finally, taxpayers could defer recognition of income or gain by using the installment sale rules. Under the installment sale rules (which were amended by the Act), the buyer gives the seller a note for the property and the note is paid in subsequent years. The buyer immediately obtains depreciation deductions on the property, but the seller recognized income or gain only as installments were received. This mismatch of income and deductions, as a result of the deferral of the recognition of income or gain, resulted in a substantial tax reduction.

Finally, the Congress was aware that rapid depreciation, high interest deductions, favorable recapture rules, and the installment sale method were combined in tax-oriented real estate shelters to achieve low or even negative effective tax rates. A negative tax rate results when tax deductions are larger than the property's gross income, in present value terms. In such a situation, the government in effect provides a cash subsidy. Thus, the tax system may have encouraged investment in certain real property projects which had a fairly low pre-tax rate of return. For example, despite the reported glut of rental housing in certain regions of the country, syndicated tax shelters continued to build. Investors could more readily afford to finance construction in markets with high vacancy rates because of the generous depreciation deductions and other tax benefits associated with certain residential property. However, the nation's economic growth is reduced to the extent that investment is diverted from more productive investments, with a higher pre-tax rate of return.

The Congress believed that slowing down the rate at which real property could be depreciated would have a salutary effect on the problems identified above.

Explanation of Provisions

Under the Act, the minimum recovery period for domestic real property qualifying as recovery property is generally increased from 15 years to 18 years. Furthermore, the Act adopts a mid-month convention. Under that convention, generally real property qualifying as recovery property placed in service (or disposed of) by a taxpayer at any time during a month is to be treated as having been placed in service (or disposed of) by the taxpayer in the middle of that month, rather than at the beginning of the month. The Secretary is to prescribe tables of recovery percentages to implement these provisions of the Act. The Congress intended that those tables would prescribe recovery percentages for property depreciated under an accelerated method or, pursuant to an election under section 168(a)(3), the straight-line method.[3]

The rules described above were intended to apply to all real property qualifying as recovery property, including property financed with the proceeds of tax-exempt obligations (as to which use of a straight-line method is generally required under section 168(f)(12)).[4] However, neither the change from 15 years to 18 years nor the mid-month convention applies to low-income housing described in section 1250(a)(1)(B)(i), (ii), (iii), or (iv).

The Act makes numerous conforming amendments. For example, in lieu of depreciating real property (including low-income housing) qualifying as recovery property on an accelerated basis, the taxpayer generally may elect to depreciate it on a straight-line basis over 18, 35, or 45 (but not 15) years. As further examples, except in the case of low-income housing, the mid-month convention is to be used in depreciating real property used predominantly outside the United States, real property constituting tax-exempt use real property, and real property depreciated under the straight-line method, as well as in determining collateral tax consequences such as the effect of depreciation on earnings and profits under section 312(k) and the applicability of the alternative minimum tax to corporations.

The Act continues the rule of prior law generally to the effect that any component of a building not constituting a substantial improvement under section 168(f)(1)(C) is to be depreciated in the same manner as the building itself, with a recovery period beginning on the later of the date the component or the building is placed in service. However, in the case of a building placed in service by the taxpayer before January 1, 1981, components placed in service by the taxpayer after December 31, 1980, and before March 16, 1984, are to be depreciated, as a separate building, in the same manner as the first such component placed in service after December 31, 1980. Similarly, in the case of a building placed in service by the taxpayer before March 16, 1984, components placed in service by the taxpayer after March 15, 1984, are to be depreciated, as a separate building, in the same manner as the first such component placed in service after March 15, 1984.

If a transferor transfers real property qualifying as recovery property to a transferee in a tax-free transaction described in section 168(f)(10)(B)(i), the Act was not intended to change the rule of prior law. Thus, the transferee should be treated as the transferor for purposes of computing allowable depreciation deductions with respect to so much of the basis of the property in the hands of the transferee as does not exceed the adjusted basis of the property in the hands of the transferor immediately before the transfer. For example, assume that a partnership placed real property qualifying as recovery property in service on March 10, 1984, and commenced

[3] The Treasury has prescribed these tables. See Treasury Department News Release R-2890 (October 22, 1984).

[4] A technical amendment may be appropriate with respect to the depreciation of real property financed with the proceeds of tax-exempt obligations.

depreciating the property on a straight-line basis over 15 years. On September 15, 1985, assume that there is a sale or exchange of 50 percent of the total interest in the partnership's capital and profits. Under section 708, the partnership is treated as having been terminated under section 731 and a new partnership is treated as having been created under section 721. Under section 168(f)(10)(B)(i), the new rules apply to the property in the hands of the new partnership, but only to the extent the basis of the property in the hands of the new partnership exceeds its adjusted basis in the hands of the old partnership immediately before the section 708 termination. To the extent adjusted basis did not increase, the new partnership must continue use of 15-year depreciation under the straight-line method.[5] (If less than 50 percent of the total interest in the partnership's capital and profits is sold or exchanged, so that there is no partnership termination, and the partnership has a section 754 election (relating to optional basis adjustments) in effect, any increase in basis is to be subject to the new rules.)

On the other hand, the Congress intended different results in cases described in section 168(f)(10)(B)(ii) or (iii) (but not in section 168(f)(10)(B)(i)) of prior law. In any such case, the Congress generally intended that the new rules would be fully applicable to real property qualifying as recovery property in the hands of the transferee unless the transferor had made an election with respect to the property under section 168(a)(3). A technical amendment will be recommended in this regard.

Effective Dates

The provisions are effective for property placed in service by the taxpayer after March 15, 1984 (after June 22, 1984, in the case of the mid-month convention). However, the provisions do not apply to property the construction of which was commenced by the taxpayer before March 16, 1984 (before June 23, 1984, in the case of the mid-month convention). Nor do they apply to property that the taxpayer was under a binding contract, entered into before March 16, 1984 (before June 23, 1984, in the case of the mid-month convention), to construct or acquire. Furthermore, if the taxpayer transfers, whether or not in a taxable transaction, his rights in any such property under construction or such contract to construct or acquire property to another taxpayer, the provisions do not apply to the property in the hands of the transferee-taxpayer so long as the property was not placed in service before the transfer by the transferor-taxpayer.[6] However, the general transitional rules do not apply unless the property is placed in service by the taxpayer before January 1, 1987.

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[5] If, in this example, the partnership had placed the property in service on March 10, 1980, instead of March 10, 1984, the property would not qualify as recovery property and ACRS would not be available to the new partnership.

[6] Under the Act, for purposes of the general transitional rules, property will not be treated as placed in service by a taxpayer holding such real property as section 1221(l) property (relating to inventory and similar property) merely because the property is held for rental or rented prior to the time it is sold. However, that rule will cease applying to any such property of the taxpayer held by it on January 1, 1985. The section 1221(l) property will not be eligible for depreciation deductions in the hands of the taxpayer. No inference was intended that property held by a taxpayer as section 1221(l) property may be depreciated by the taxpayer.

In elaboration of the general transitional rules, assume that taxpayer A signed a binding contract on March 10, 1984, to have a building constructed. On December 1, 1984, A sells its rights under the contract to B. On March 15, 1985, B sells its rights under the contract to C. The building is placed in service by C, on November 1, 1985. Since neither A nor B placed the property in service, the provisions do not apply to the building in C's hands. On the other hand, if the building is not placed in service by C until November 1, 1987, the general transitional rules would not apply.

A partnership may have commenced construction of, or signed a binding contract to acquire or construct, real property before March 16, 1984 (before June 23, 1984, in the case of the mid-month convention). Subsequently, but prior to the time the property is placed in service, interests in the partnership may be sold or exchanged. If, by reason of such sales or exchanges, there is a termination of the partnership and the creation of a new partnership under section 708, the partnership is to be treated as having transferred its rights in its contract or the property to the new partnership (through its partners) for purposes of the general transitional rules.

Construction is not to be considered to have commenced solely because drilling is performed to determine soil conditions, architect's sketches or plans are prepared, or a building permit is obtained. Generally, construction will be considered to have commenced when land preparations and improvements, such as clearing, grading, excavation (including any significant required archaeological excavation), or filling, are undertaken. However, construction will not be considered to have commenced solely because clearing or grading work is undertaken, or drainage ditches are dug, if such work is undertaken primarily for the maintenance or preservation of raw land and existing structures and is not an integral part of plan for construction. In the case of the demolition of existing structures where construction has not otherwise commenced, construction is considered to commence when demolition begins if the demolition is undertaken to prepare the site for specific construction. Construction will not be considered to have commenced solely because of the demolition of existing structures if demolition is not undertaken as part of a plan for the construction of specific buildings or improvements. However, demolition is to be treated as the commencement of construction if both the demolition and the formally approved plan of construction are consistent with the recommendations of a feasibility study evidenced by internal documents of the taxpayer in existence when demolition commenced.

Construction of property is considered to have begun before March 16, 1984 (before June 23, 1984, in the case of the mid-month convention), if the property is an integral part of an integrated facility and construction of part of that facility began before March 16, 1984 (before June 23, 1984, in the case of the mid-month convention). An integrated facility is a multi-property facility constructed as a single project on a single site which is to be operated as a single, unitary facility as described in a written plan (evidenced by internal documents of the taxpayer, such as purchasing and financing documents) existing on March 15, 1984 (on June 22, 1984, in the case of mid-month convention). Property is an integral part of an integrated facility if:

(1) the property is described as part of the same project in written plans of the taxpayer in existence on March 15, 1984 (on June 22, 1984, in the case of the mid-month convention);

(2) the property is an integral part of the planned operation of the project when a significant part of the project will first be placed in service; and

(3) the property will be constructed during the same time as the rest of the project.

Thus, for example, three separate apartment buildings are not part of one integrated facility if it is planned that only one building will be placed in service initially. On the other hand, if a taxpayer plans to construct lodging and convention facilities and to operate them as a unit, then both a hotel and a separate convention center to be constructed during the same time on a single site are part of the same integrated facility because both properties are necessary for the consummation of the taxpayer's plan. However, if the hotel is planned to be ready to be placed in service in 1985, and construction of the convention center is not planned to begin until 1986, then those properties are not part of an integrated facility.

Although improvements such as parking lots, access roads, and utility hook-ups may be part of an integrated facility, the start of construction of such property (which can be used in connection with any type of facility) is not to be considered the start of construction of other property in the facility.

For purposes of the general transitional rules, a contract with respect to the property is to be treated as binding only if it is enforceable under State law and does not limit damages to a specified amount that is relatively minor. (A contract which does limit damages to a relatively minor amount may more properly be treated as an option than a binding obligation.) A contract that limits damages to an amount equal to at least 5.0 percent of the total contract price will not be treated as limiting damages in an amount that is relatively minor. A contract is binding even if subject to a condition, so long as the condition is not within the control of either party. For purposes of the general transitional rules, a contract will not be treated as ceasing to be binding merely because any term is to be determined by a standard beyond the control of either party or there is a bilateral agreement to reduce the purchase price of the property by no more than 20 percent or change the financing terms.

For purposes of the Act's rules regarding the depreciation of components, if the components are of a building to which the general transitional rules apply, the building is to be treated as having been placed in service by the taxpayer before March 16, 1984 (but not the components). However, this rule applies only if the components are placed in service after December 31, 1986, in which case the components would be depreciated under the new rules. If the components are placed in service before that date, they should be depreciated in the same manner as the building itself.

Under the Act, a special transitional rules applies with respect to property contracted for by the taxpayer on or before May 1, 1984, if bonds to finance the property were issued before 1984, and an architectural contract with respect to such property was entered into before March 16, 1984. The provisions do not apply to any such property.

Revenue Effect

The provisions are estimated to increase fiscal year budget receipts by $55 million in 1984, $291 million in 1985, $786 million in 1986, $1,478 million in 1987, $2,244 in 1988, and $3,043 in 1989.

2. Depreciation Recapture in Installment Sales (sec. 112 of the Act and sec. 453 of the Code)[7]

Prior Law

In a sale or other disposition of depreciable real or personal property, some or all of the gain may be taxed at the time of the disposition as ordinary income under the depreciation recapture rules of sections 1245 and 1250. The amount taxed as ordinary income equals all or a part of prior depreciation deductions taken with respect to the property up to the amount of gain recognized. For example, in the case of a sale of personal property, all gain generally is taxed as ordinary income under the depreciation recapture rules of section 1245 to the extent of all prior depreciation deductions with respect to the property. As a further example, if part or all of the cost of nonresidential property in the 15-year real property class was recovered under the accelerated method, all gain recognized on disposition is treated as ordinary income to the extent of all prior recovery deductions.

If the disposition was pursuant to an installment sale, generally no gain or depreciation recapture income was recognized in the taxable year of the sale if no principal payments were made or deemed made in that taxable year. Except as provided in section 453(i) (relating to installment sales of business property which the seller elected to expense under section 179), gain and depreciation recapture income were taxed only as principal payments were made on the installment obligation. Under Treas. reg. sec. 1.1245-6(d)(1) and Treas. reg. sec. 1.1250-1(c)(6), gain recognized, as principal payments were made, was first treated as ordinary income up to the amount of recapture income in the transaction. Typically, a portion of each principal payment was treated as a recovery of basis. Generally, under the installment method, the portion of each principal payment treated as a recovery of basis equalled the amount of the payment times a fraction the numerator of which was the seller's adjusted basis in the property and the denominator of which was the total purchase price.

Thus, for example, assume that a taxpayer sold an item of real property with a $20 basis for a note with a principal amount of $100. Assume further that $20 in principal was paid in the taxable year immediately following the taxable year of the sale and in each of the 4 taxable years thereafter and that, of the $80 gain, $10 was section 1250 recapture income. Under prior law, in the taxable year of the sale, the taxpayer recognized no income from the sale.

[7] For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 172; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 465-466; Senate floor amendment, 130 Cong. Rec. S. 4339 (April 11, 1984); Senate floor amendment, 130 Cong. Rec. S. 4530-4536 (April 12, 1984); H. Rep. No. 98-861 (June 23, 1984), pp. 1008-1009 (Conference Report); and H. Con. Res. 328, 130 Cong. Rec. H. 7530.

In the next taxable year, the taxpayer recognized $16 ($20 x $80/$100) of income from the sale, $10 of which was section 1250 recapture income, and treated $4 ($20 x $20/$100) as a recovery of basis. In each of the 4 succeeding taxable years, the taxpayer recognized $16 of income from the sale, none of which was recapture income, and treated the remaining $4 as a recovery of basis.

Reasons for Change

In an installment sale, the buyer gives the seller a note which is to be paid in subsequent years. The buyer immediately obtains depreciation deductions on the property based on its cost, but, under prior law, the seller recognized income only as installments were received. The Congress was concerned that this mismatch of income and deductions had been exploited to lower the overall effective rate of tax.

The Congress was also concerned about the ability of the recapture rules to curb the incentive to "churn" property, i.e., to replace property as soon as its cost had been recovered through depreciation deductions. The installment sale rules permitted the deferral of recapture and capital gains tax and thus circumvented the barrier to churning. Taxpayers using the installment method were able to multiply tax benefits by selling property after the associated tax benefits were exhausted, which often occurred well before the expiration of the property's economic useful life, and acquiring replacement property.

It was argued that gain on property, whether from appreciation in value or prior depreciation deductions, should be deferred until installment payments are made, i.e., until the seller gets cash to pay tax. However, with respect to section 1245 or 1250 recapture income, the seller has already obtained the benefits of depreciation deductions taken on the property prior to the sale. The Congress believed that deferral of gain attributable to prior depreciation deductions could not be justified on the grounds that the seller lacked the means to pay tax.

Therefore, the Congress decided that tightening the prior-law installment sale rules was necessary to reduce the tax revenue cost associated with certain churning, sale-leaseback, and other tax shelter transactions, narrow the tax advantage of investors who churn property compared to those investors who hold property for substantially all of its economic life, and make it more difficult for investors to multiply the tax benefits of the ACRS system to achieve negative effective tax rates (i.e., subsidies) by engaging in churning transactions.

Explanation of Provision

Under the Act, in any installment sale of depreciable real or personal property, all depreciation recapture income under sections 1245 and 1250 (including amounts treated as ordinary income under section 1250 by reason of section 291(a), as amended by the Act) is recognized in the taxable year of the disposition, even if no principal payments are received in that year. Any gain in excess of the depreciation recapture income is taken into account under the installment method. In determining how much of any principal payment constitutes a recovery of basis or gain, under the installment method, the seller's adjusted basis is to be increased by the amount of the depreciation recapture income. In applying these provisions, principal amounts are to be determined under general Code rules.

Thus, in the example above, $10 would be includible as section 1250 recapture income in the taxable year of the sale even though no principal payments are received in that year. In each of the 5 taxable years thereafter, $14 ($20 x ($80-$10)/$100) would be includible as gain, none of it as recapture income, and $6 ($20 x ($20 + $10)/$100) would be a recovery of basis. If, in the example above, $20 of principal payments were received in the taxable year of the sale and in each of the 4 taxable years thereafter, $24 would be includible in income in the year of the sale, $10 of it as recapture income, and $6 of basis would be treated as recovered in that year. In each of the 4 succeeding taxable years, $14 would be includible as gain, none as recapture income, and $6 would be a recovery of basis. In this latter example, if for $80 the taxpayer disposed of the installment obligation under section 453B(a) at the beginning of its second taxable year after the sale, $56 would be includible. None of the $56 would be recapture income.

The taxpayer may own a partnership interest which, if sold by the taxpayer for cash, would generate some depreciation recapture income to the taxpayer under section 751. If the taxpayer sold his interest on the installment basis, the provisions of the Act would apply. This is because depreciation recapture, like some other items, is a severable part of the taxpayer's partnership interest. (See the discussion relating to section 76 of the Act.)

The Act also repealed section 453(i). Property to which section 453(i) applied is now subject to the provisions of the Act.

Effective Date

The provision is effective with respect to dispositions made after June 6, 1984. However, the provision does not apply to dispositions pursuant to contracts which were binding on March 22, 1984, and at all times thereafter. Nor does the provision apply to certain dispositions of all or substantially all of the personal property of a cable television business.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $24 million in 1984, $56 million in 1985, $212 million in 1986, $219 million in 1987, $224 million in 1988, and $234 million in 1989.

3. Provisions Relating to Films (sec. 113 of the Act and secs. 48 and 168 of the Code)[8]

Prior Law

Under ERTA, personal property of a character subject to the allowance for depreciation which is placed in service by a taxpayer after December 31, 1980, generally qualifies as recovery property, eligible for depreciation under ACRS. Most personal property qualifying as recovery property can be depreciated, on an accelerated basis, over 3 or 5 years.

However, under section 168(c)(2), recovery property includes only tangible property. Furthermore, under section 168(e), recovery property, for depreciation purposes, generally does not include tangible depreciable property which the taxpayer elects to depreciate under the unit-of-production method, the income forecast method, or any other method of depreciation not expressed in a term of years. Under the income forecast method, a taxpayer generally deducts in a taxable year a percentage of its basis in the property involved. This percentage is determined by dividing the income derived from the property in that taxable year by all the income which the taxpayer reasonably expects to derive from the property.

Regular investment credits are allowed with respect to a taxpayer's qualified investment in certain tangible personal property. Under section 46(c)(2), in the case of eligible property which is not recovery property for regular investment credit purposes, the amount of the credit depends on the useful life of the property. In general, if the useful life is 3 years or more but less than 5 years, a credit of 3 1/3 percent is allowed. If the useful life is 5 years or more but less than 7 years, a credit of 6 2/3 percent is allowed. In the case of property with a useful life of 7 years or more, a 10-percent credit is allowed. Under section 46(c)(7), in the case of property qualifying as recovery property for regular investment credit purposes, a 6-percent credit is allowed for 3-year property, and a 10-percent credit is allowed for 5-year property. In the case of certain new qualified films (i.e., a new motion picture film or video tape created primarily for use as public entertainment or for educational purposes but not any film or tape the market for which is primarily topical or otherwise transitory in nature), section 48(k) generally provided that any credit allowed under section 46(c)(2) was at a special 6 2/3-percent rate, but only with respect to specified costs. Those costs might have included certain contingent capital cost amounts which are in effect deductible when paid or incurred

[8] For legislative background of the provisions, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 173; Senate floor amendment 130 Cong. Rec. S. 4543 (April 12, 1984); and H. Rep. No. 98-861 (June 23, 1984), pp. 1009-1010 (Conference Report).

under the principles of *Associated Patentees* v. *Commissioner*, 4 T.C. 979 (1945), acq. 1959-2 C.B. 3.

The language of prior law was unclear as to whether films (including video tapes) were generally to be treated as tangible personal property. While it was held that negatives of feature films qualified as tangible personal property for regular investment credit purposes (see, e.g., *Walt Disney Productions* v. *United States*, 480 F.2d 66 (9th Cir. 1973), cert. denied, 415 U.S. 934 (1974)), Treas. reg. section 1.48-1(f) is to the contrary.

Reasons for Change

Despite the special credit rules of section 48(k), the Congress understood that some taxpayers took the position that although films the cost of which was recovered under the income forecast method, the unit-of-production method, or a similar method were not recovery property for cost recovery purposes (see sec. 168(c)(2)), as tangible property they nevertheless were eligible for the regular investment credit allowable with respect to recovery property under section 46(c)(7) and were not limited by section 48(k) and section 46(c)(2).

Prior law contemplated that films were generally (1) to be depreciated or amortized under the income forecast method or a similar method, and (2) limited to whatever investment credit was available under section 48(k). The Congress determined to amend the Code to state more clearly the applicable rules.

Explanation of Provision

Under the Act, films cannot qualify as recovery property for either cost recovery or regular investment credit purposes.[9] Furthermore, only section 48(k) may be applicable to allow a credit.

The Act clarifies that the general basis adjustment rules of section 48(q) are applicable to films. In applying this rule, the Congress intends that when a tax credit is allowable with respect to deductible contingent amounts, the "deductible" amount is to be reduced by the amount of what would otherwise have been the reduction in depreciable basis.

In addition, the Act clarifies that if property is not treated as recovery property by reason of section 168(e), such property is not to be treated as recovery property for investment credit purposes.

Finally, since section 48(k) contains its own at-risk rules, the Act clarifies that the general investment credit at-risk rules of section 46(c)(8) and (9) are not to apply to qualified films as defined in section 48(k)(1)(B).

Effective Dates

The provision to the effect that films cannot qualify as recovery property is effective with respect to films placed in service before, on, or after the date of enactment of the Act. However, that rule does not apply to any qualified film placed in service by the tax-

[9] Furthermore, the Congress did not intend that films be treated as tangible property so as to be eligible for depreciation under the rules in effect prior to the adoption of ERTA. A technical amendment to this effect may be appropriate.

payer before March 15, 1984, if ACRS was claimed with respect to such film on a return filed before March 16, 1984. Therefore, the rule does not itself operate to disallow regular investment credits with respect to any such film. Furthermore, the rule does not apply to any qualified film placed in service before 1985, so long as (1) ACRS is claimed with respect to the film, and (2) 20 percent or more of the production costs for the film were incurred prior to March 16, 1984. However, investment credit with respect to any such film is to be determined solely under the rules of section 48(k).

The provision clarifying that property not treated as recovery property by reason of section 168(e) is not to be treated as recovery property for investment credit purposes is effective as if included in ERTA.

The provisions relating to the section 48(q) basis adjustment and the regular investment credit at-risk rules of sections 46(c)(8) and (9) have the same effective dates as section 48(q) and sections 46(c)(8) and (9), respectively.

Revenue Effect

The provision is estimated to increase budget receipts by less than $10 million annually.

4. Provisions Relating to Sound Recordings (sec. 113 of the Act and secs. 48 and 168 of the Code)[10]

Prior Law

Under ERTA, personal property of a character subject to the allowance for depreciation which is placed in service by a taxpayer after December 31, 1980, generally qualifies as recovery property, eligible for depreciation under ACRS. Most personal property qualifying as recovery property can be depreciated, on an accelerated basis, over 3 or 5 years.

However, under section 168(c)(2), recovery property includes only tangible property. Furthermore, under section 168(e)(2), recovery property, for depreciation purposes, generally does not include tangible depreciable property which the taxpayer elects to depreciate under the unit-of-production method, the income forecast method, or any other method of depreciation not expressed in a term of years. Under the income forecast method, a taxpayer generally deducts in a taxable year a percentage of its basis in the property involved. This percentage is determined by dividing the income derived from the property in that taxable year by all the income which the taxpayer reasonably expects to derive from the property. In the case of sound recordings, contingent amounts (e.g., royalties, residuals, and participations) are frequently paid to songwriters, publishers, unions, artists, and others as part of capital cost. In many instances, such amounts (not including advance royalties) are in effect deductible when paid or incurred under the principles of *Associated Patentees v. Commissioner*, 4 T.C. 979 (1945), acq., 1959-2 C.B. 3.

Investment credits are allowed with respect to a taxpayer's qualified investment in certain tangible personal property. For example, under section 46(c)(7), in the case of property qualifying as recovery property for investment credit purposes, a 6-percent credit is allowed for 3-year property and a 10-percent credit is allowed for 5-year property.

Prior law was unclear as to whether sound recordings were tangible personal property, eligible for ACRS and the investment credit. It was the position of the Treasury Department that sound recordings were not tangible property (Treas. reg. sec. 1.48-1(f)). But some courts held to the contrary (see, e.g., *EMI North America, Inc. v. United States*, 675 F. 2d 1068 (9th Cir. 1982), holding that sound recordings were tangible property for investment credit purposes).

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[10] For legislative background of the provisions, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 173; Senate floor amendment, 130 Con. Rec. S. 4491-4492 and 4494 (April 12, 1984); and H. Rep. No. 98-861 (June 23, 1984), pp. 1010-1011 (Conference Report).

With certain exceptions, property which is used predominantly outside the United States does not qualify for the investment credit or for maximum benefits under ACRS. Furthermore, property used by a tax-exempt organization or a governmental unit generally does not qualify for the investment credit.

Reasons for Change

Sound recordings were frequently depreciated under the income forecast method or another method of depreciation not expressed in a term of years. The Congress understood that, in the case of sound recordings, such methods of depreciation were often more generous than ACRS.

For depreciable tangible personal property, ACRS and the investment credit rules were designed to provide tax benefits to a taxpayer generally worth, on a present-value basis, no more than what the value of the tax benefits would have been had the property been expensed in the taxable year it was placed in service. The use of a method of depreciation more generous than ACRS, combined with an investment credit, frequently provided taxpayers owning sound recordings with tax benefits that were greater than current expensing would have provided. The Congress believed such benefits to have been excessive.

Finally, the Congress also believed that it was necessary to clarify whether the distribution of the original or copies of master sound recordings outside the United States caused the property to be treated as used predominantly outside the United States.

Explanation of Provision

Taxpayers are provided with 2 options with respect to each new sound recording, generally as defined in section 280(c)(2), the original use of which commences with the taxpayer. First, taxpayers generally can elect to treat the sound recording as recovery property which is 3-year property to the extent they have an ownership interest in it. Under that election, the property may be depreciated under the 3-year property ACRS rules and a 6-percent investment credit will be allowed (if the property is otherwise eligible for the credit). Second, taxpayers can treat it as intangible property, recovering its cost under the income forecast method or a similar method, but no investment credit is available. Unless all taxpayers with an ownership interest in the sound recording elect the first option, the second option will apply. No investment credit is allowed with respect to sound recordings the original use of which does not commence with the taxpayer, and the costs of such a sound recording are to be recovered under the income forecast method or a similar method.

If the first option is elected, all capital costs, including all non-U.S. production costs and all contingent capital cost amounts paid or incurred in the taxable year the property is placed in service or the taxable year thereafter, are recovered as if the property constituted 3-year recovery property. Contingent capital cost amounts paid or incurred in the second year are to be recovered over 3 years beginning with that year. Contingent capital cost amounts paid or incurred in other years are not treated as 3-year property for cost recovery purposes but are recovered under the general rules applicable to intangible property. For purposes of determining any investment credit, qualified investment includes only production costs allocable to the United States or possessions of the United States. However, qualified investment does not include any contingent amounts which are not eligible for treatment as 3-year property for cost recovery purposes. Any investment credit allowed with respect to contingent amounts incurred in the taxable year after a sound recording is placed in service is allowed in the year those amounts are paid or incurred.

The investment credit recapture rules of section 47 are applicable to sound recordings with respect to which the first option is elected.

The distribution of the original or copies of a master sound recording outside the U.S. is not treated as a use of the property outside the U.S.

No inference was intended as to the proper treatment of sound recordings under prior law.

The rules of section 48(q) (relating to adjustments in the depreciable basis of property on account of the investment credit) apply to sound recordings, but, since the provision contains its own at-risk rules, the general investment credit at-risk rules do not.

Effective Date

The provision applies to sound recordings placed in service after March 15, 1984.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $5 million in 1984 and by $10 million annually in the years 1985–1989.

5. Definition of New Property for Tax Credit Purposes (sec. 114 of the Act and sec. 48 of the Code)[11]

a. Energy property

Prior Law

Regular investment tax credits and energy property tax credits are allowed with respect to certain kinds of new property. In determining whether property is new property for purposes of the regular investment credit, property subject to a lease was treated as originally placed in service not earlier than the date the property was used under the lease, but only if the property was leased within 3 months of the date it was placed in service. No similar rule applied in determining whether property was new for purposes of the energy property tax credit.

Reasons for Change

The Congress saw no reason why the 3-month rule, which it has determined to be appropriate for regular investment credit purposes, was not equally appropriate for energy property tax credit purposes. Furthermore, the Congress believed it would simplify the tax law if the same 3-month rule applied for both the regular investment tax credit and the energy property tax credit since both credits are often available with respect to the same property.

Explanation of Provision

Under the Act, the 3-month rule (as amended by the Act) applicable in determining whether property is new for regular investment credit purposes is applicable in determining whether property is new for energy property tax credit purposes as well.

Effective Date

The provision is effective for property which is actually first placed in service after April 11, 1984.

Revenue Effect

The provision is estimated to have a negligible effect on budget receipts.

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[11] For legislative background of the provisions, see: Senate floor amendment, 130 Cong. Rec. S. 4338-4339; and H. Rep. No. 98-861 (June 23, 1984), pp. 1252-1253 (Conference Report).

b. Investment credit property

Prior Law

Investment tax credits are allowed with respect to certain kinds of new property. In determining whether property is new property for this purpose, property subject to a lease was treated as originally placed in service not earlier than the date the property was used under the lease, but only if the property was leased within 3 months after such property was placed in service (sec. 48(b)).

Prior law also treated as new property for this purpose certain property the reconstruction of which was completed by the taxpayer (sec. 48(b)(1)).

Reasons for Change

The Congress determined that the language of the 3-month rule needed clarification. For example, under the language of prior law, it could have been argued that if taxpayer A placed eligible property in service and then, within 3 months, sold it to taxpayer B who leased it to taxpayer C, the property qualified as new property in the hands of B. The purpose of the 3-month rule is generally to permit a person who originally places property in service to transfer its rights in the property and then lease the property from the transferee without causing the property to fail to qualify as new property in the hands of the transferee—so long as the transaction occurs within 3 months of the original in-service date.

Explanation of Provision

For investment credit purposes, the 3-month rule is clarified. Only property which is originally placed in service by a person[12] and which is leased to that person, in a transaction qualifying as a lease for Federal income tax purposes, within 3 months of the date such property was originally placed in service by that person shall be treated as originally being placed in service not earlier than the date it is used under the lease. The rule is made applicable for purposes of the energy property tax credit as well.

Suppose, for example, that a taxpayer buying property from a manufacturer takes delivery of it and places it in service. Within 3 months after the taxpayer places it in service, the property is sold (or the purchase order assigned) by such taxpayer to another taxpayer who then leases it in a "true" lease to the first taxpayer. Under the Act, the property is to be treated as originally placed in service not earlier than the date it is used under that lease.

In amending the 3-month rule, the Congress inadvertently deleted that part of prior law allowing an investment credit with respect to the reconstruction of certain property by the taxpayer (section 48(b)(1)). A technical amendment reinstating that rule will be recommended. Under any such technical amendment, the 3-month rule would not be applicable. Thus, property reconstructed by a taxpayer and then sold and leased back by the taxpayer within 3

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[12] As under prior law, this person may be a lessor of the property, as well as its actual user. For example, if one person leases property not previously placed in service to another person, generally the property is originally placed in service by the first person.

months of the date the reconstructed property was originally placed in service by the taxpayer would be treated as originally placed in service when actually originally placed in service.

Effective Date

The provision is effective for property which is actually first placed in service after April 11, 1984.

Revenue Effect

The provision is estimated to have a negligible effect on budget receipts.

J. Foreign Provisions

1. Maintaining the Source of U.S. Source Income (sec. 121 of the Act and sec. 904 of the Code)[1]

Prior Law

In general, the United States taxes U.S. corporations on their worldwide income, but grants a credit for foreign income taxes paid or accrued. The credit is limited to ensure that foreign taxes can offset only U.S. tax on foreign source taxable income. The limitation is determined by using a simple ratio of foreign source taxable income to worldwide taxable income. The limitation is computed on a worldwide, or overall, basis so that taxes paid to one foreign country in excess of the U.S. rate can offset U.S. tax that would be imposed on other low-taxed or untaxed foreign income.

In addition to a credit for taxes paid directly, a credit is also permitted for certain taxes paid by foreign corporations at least 10 percent of the voting stock of which is owned by a U.S. corporation. Dividends to these U.S. corporations carry with them a proportionate amount of the foreign taxes paid by the foreign corporation.

The Code defines U.S. and foreign source income. U.S. source income includes, generally, dividends and interest paid by U.S. persons. U.S. source income also includes, among other things, income from insuring U.S. risks. Ordinarily, dividends and interest that a foreign corporation (not doing business in the United States) pays are foreign source income. (A pro rata portion of dividends and interest paid by a foreign corporation is U.S. source income when half or more of the foreign corporation's gross income over a three-year period is effectively connected with a U.S. trade or business.)

Under prior law, U.S. taxpayers may have been able to convert the source of some U.S. source income to foreign source income by routing the income through a foreign subsidiary. This would be accomplished by paying interest, insurance premiums, or other amounts to the foreign subsidiary. The U.S. source income paid to the foreign subsidiary may have become foreign source income of the group to which the foreign subsidiary belonged, either on its subsequent repatriation to the U.S. parent (or other U.S. shareholders) as a dividend, as interest, or as an inclusion in the U.S. parent's income under subpart F or the foreign personal holding company rules.

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[1] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 141; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1346–48; House floor amendment, 130 Cong. Rec. H2738 (April 11, 1984); "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 128; S. Prt. No. 98-169, Vol. I (April 2, 1984), pp. 386-90; H. Rep. No. 98-861 (June 23, 1984), pp. 918-25 (Conference Report); and H. Con. Res. 328, 130 Cong. Rec. S8944 (June 29, 1984), H7525-26 (June 29, 1984).

The operation of these rules is illustrated by the following example of an insurance subsidiary established by one or more U.S. corporations in a foreign country. The foreign insurance company earned all its income from insuring U.S. risks of U.S. companies.[2] The income of such a foreign insurance company was and is U.S. source income, but that income, so long as the company avoids becoming engaged in a U.S. business, is not subject to the regular graduated-rate U.S. income tax. (If such an insurance company were a U.S. corporation, it would be subject to the regular graduated-rate U.S. tax.) The Code imposes at most a 1-percent excise tax on premiums for the reinsurance of U.S. risks received by foreign insurance companies not doing business in the United States. Typically, the insurance company would be established in a tax haven that would impose little or no tax on its income.

Subpart F generally treats the U.S. owner of a tax-haven insurance company insuring U.S. risks as if it had received a distribution from the insurance company in the amount of the income that the insurance company earned. That subpart F inclusion, even though wholly attributable to U.S. source income, was treated as entirely foreign source income under prior law. (Similarly, the payment of a dividend or interest by a foreign subsidiary to its U.S. shareholders, or an inclusion in a U.S. shareholder's income under the foreign personal holding company rules, was treated under prior law as entirely foreign source income even if wholly attributable to U.S. source income received by the foreign subsidiary.) As a result, the income of the insurance company in the example might have escaped U.S. tax on the subpart F inclusion to its U.S. owners. This could occur because the subpart F inclusion, as foreign source income, could absorb foreign tax credits that arose from taxes imposed by countries other than the tax haven: foreign taxes from one country can offset U.S. tax on income from another country. The foreign source income could also absorb excess foreign tax credits carried over from another taxable year. Furthermore, if the insurance company were located, not in a tax haven, but in a country imposing higher corporate taxes than the United States, the credit for those foreign taxes would eliminate any U.S. tax on the insurance company's income. Thus, high foreign taxes on income from foreign business operations could shelter the insurance company's income from U.S. tax. Had this income been received by the U.S. shareholders directly, through a foreign branch, or through a U.S. subsidiary operating abroad, the income would have retained its U.S. source and no foreign tax credit could be claimed against it.

Reasons for Change

The purpose of the foreign tax credit is to prevent international double taxation. A fundamental premise of the credit is that it should offset only U.S. tax on foreign income, and not U.S. tax on U.S. source income. Because prior law determined the source of dividend, interest, subpart F, and foreign personal holding compa-

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[2] Congress did not express a view as to when a payment of an amount purporting to be a premium covering a risk of a person related to the insurer constitutes nondeductible self-insurance.

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ny income by reference to the direct (or deemed) payor, the source of income was converted from U.S. to foreign, and the foreign tax credit limitation was inflated when a foreign corporation received U.S. source income that was subsequently repatriated as foreign source dividends (actual or deemed), interest, or otherwise. This inflation of the foreign tax credit allowed U.S. companies with excess foreign tax credits to reduce the U.S. tax on what Congress considers to be (and what the Act treats as) U.S. source income.

Congress was concerned that under prior law income that arose in the United States and that was eventually subject to tax in the hands of a U.S. person became foreign source merely because it was received by a foreign entity. Congress believed that this system distorted the foreign tax credit limitation and that, in general, the United States should retain primary taxing jurisdiction in such a case, even when the U.S. source income passes through intermediate foreign corporations with certain levels of U.S. ownership. In general, there should not be one foreign tax credit treatment for U.S. persons who earn U.S. source income directly (either through a U.S. office or a foreign branch of a U.S. office), and another treatment for those who earn it indirectly through a separate foreign entity. Accordingly, Congress decided to amend the source rules so that income of U.S. persons that first arises in the United States retains its U.S. source whether or not it passes through certain separate foreign entities.

The prior law source rules arguably allowed the circumvention of the foreign tax credit limitation. The creation of foreign income that either attracted high foreign taxes directly or absorbed foreign tax credits that arose from unrelated high-taxed foreign income passed the cost of high foreign taxes from the U.S. taxpayer to the U.S. Government. The Act prevents that result by its general rule that ensures full U.S. tax when U.S. source income flows through a U.S.-owned foreign corporation. Ensuring full U.S. tax in this situation also eliminates the competitive tax advantage available under prior law to U.S. taxpayers who first exported capital to be invested in the United States to foreign subsidiaries rather than investing it directly.

Explanation of Provision

The Act prevents the conversion to foreign source income of certain U.S. source income earned through a foreign corporation. In general, the Act provides that subpart F and foreign personal holding company inclusions are U.S. source income to the extent attributable to U.S. source income of the foreign corporation with respect to which the inclusions are required. Further, if a foreign corporation has earnings and profits and 10 percent or more of the earnings and profits are attributable to U.S. sources, then the Act provides that (1) interest paid by the foreign corporation to its 10-percent U.S. shareholder (or a related person) is U.S. source income to the extent properly allocable to U.S. source income of the foreign corporation, and (2) a pro rata portion of dividends paid by the foreign corporation out of the earnings and profits is U.S. source income. These amendments apply for purposes of the foreign tax credit limitation only. The rules maintaining the source of U.S.

source income apply only to subpart F and foreign personal holding company inclusions, interest, and dividends that would otherwise be treated as derived from foreign sources.

Subpart F and foreign personal holding company inclusions

The Act treats subpart F inclusions (Code sec. 951(a)) and foreign personal holding company inclusions (Code sec. 551) with respect to income of a U.S.-owned foreign corporation as derived from U.S. sources to the extent attributable to U.S. source taxable income of the foreign corporation. No *de minimis* rule prevents application of the Act's rule maintaining the source of income in the case of subpart F inclusions or foreign personal holding company inclusions.

Assume, for example, that a foreign corporation wholly owned by a U.S. corporation earns $100 of net income. Ninety dollars of the net income is attributable to the insurance of U.S. risks and $10 is attributable to the insurance of foreign risks of related parties located in other foreign countries. All of the income is subpart F income to the U.S. parent corporation (under Code section 953, and Code section 954(e) as amended by the Act). Since $90 of this $100 subpart F inclusion is attributable to U.S. source taxable income of the foreign corporation (the $90 of net income attributable to the insurance of U.S. risks), $90 of the inclusion is treated as U.S. source income of the parent corporation under the provision.

Interest payments

In addition, the Act treats certain interest paid or accrued by a U.S.-owned foreign corporation during a taxable year as derived from U.S. sources to the extent properly allocable (under regulations prescribed by the Secretary) to U.S. source income of the foreign corporation for that taxable year. Congress intended that interest be allocated for this purpose using the same method used to compute the amount of any subpart F or foreign personal holding company inclusion made with respect to the foreign corporation (*see, e.g.*, sec. 954(b)(5)). Interest covered by this rule is interest paid or accrued to a (10-percent) U.S. shareholder of the foreign corporation (sec. 951(b)) or to a person related to such a shareholder (sec. 267(b)). In addition, the Act authorizes the Secretary to prescribe regulations providing that interest paid or accrued to any person, whether or not the person is a U.S. shareholder, will be subject to the provision. Such regulations might be necessary in the case of U.S.-owned foreign corporations not all of whose U.S. owners are 10-percent U.S. shareholders.

Assume, for example, that a foreign corporation wholly owned by a U.S. corporation earns $85 of gross income, consisting of $60 of gross income from manufacturing operations in its country of incorporation, $10 of gross interest on a loan to an unrelated U.S. person, and $15 of gross interest on a loan to a U.S. affiliate engaged solely in an active business. The foreign corporation incurs total expenses of $115, consisting of $85 of manufacturing expenses and $30 of interest payments to its U.S. parent. The foreign corporation owns assets with a total fair market value of $500, consisting of assets used in its manufacturing operations worth $300, a $100 loan to the unrelated U.S. person, and a $100 loan to the U.S. affiliate. To determine how much of the $30 of interest payments to the

U.S. parent is treated as U.S. source income of the U.S. parent, the payments must be allocated to gross income of the foreign corporation from foreign and U.S. sources, respectively. The asset method is used to allocate interest under the provision. Thus, $18 of the interest paid ($30 x ($300/$500)) is allocated against the foreign corporation's $60 of gross foreign manufacturing income and $12 ($30 x ($200/$500)) against the foreign corporation's $25 of gross U.S. interest. Therefore, $12 of the $30 of interest paid by the foreign corporation to its U.S. parent is treated as U.S. source income of the U.S. parent under the provision.

Dividends

The Act also treats a portion of any dividend paid or accrued by a U.S.-owned foreign corporation as derived from U.S. sources, on the basis of a U.S. source ratio. The "U.S. source ratio" of a dividend equals the earnings and profits from U.S. sources for the taxable year out of whose earnings and profits the dividend was paid or accrued, divided by the total earnings and profits for that taxable year. Thus, the source of the earnings and profits for the particular year from which the dividend is considered to be derived for purposes of computing the deemed paid foreign tax credit (Code secs. 902 and 960) controls the extent to which the dividend is treated as derived from U.S. sources under the provision.

Assume, for example, that a foreign corporation wholly owned by a U.S. corporation has a net loss in the current year. It pays a $20 dividend in the current year out of earnings and profits for an earlier taxable year. Earnings and profits for the earlier taxable year were $100 and were entirely from foreign sources. (They derived from manufacturing and sales operations in the foreign corporation's country of incorporation; the U.S. parent had no subpart F or foreign personal holding company inclusion with respect to the foreign corporation in the earlier taxable year.) The U.S. source ratio with respect to the $20 dividend equals zero ($0/$100) and no portion of the dividend is treated as U.S. source income of the payor's foreign parent. (The 10-percent exception, discussed below, would independently exempt the dividend from the provision also.)

As another example, assume that a foreign corporation wholly owned by a U.S. corporation derives earnings and profits of $100. The foreign corporation pays a current dividend of $30 out of the earnings and profits. None of the foreign corporation's income is subject to subpart F. Assume further that earnings and profits equal net income. Fifty dollars of the earnings and profits are from U.S. sources and $50 are from foreign sources. Thus, the U.S. source ratio with respect to the $30 dividend equals one-half ($50/$100). Therefore, one-half of the $30 dividend, $15, is treated as derived from U.S. sources by the U.S. parent under the provision.

Ten-percent exception

The provision contains an exception for payments received from U.S.-owned foreign corporations with small proportional amounts of U.S. source income. The provision does not apply to interest paid or accrued during a taxable year or dividends paid out of the earnings and profits for a taxable year if the U.S.-owned foreign corporation that pays the interest or dividends has earnings and profits for that taxable year and less than 10 percent of the earnings and profits is attributable to U.S. sources. The Act uses an earnings and profits test rather than a gross income test for this purpose because use of a gross income test might allow taxpayers to defeat the purpose of the provision by earning U.S. source gross income (such as interest) offset by few expenses and sheltering that income with foreign source gross income fully or nearly offset by expenses. To prevent manipulation of the exception, the Act also provides that, for purposes of the exception, earnings and profits are determined without any reduction for interest paid or accrued by a U.S.-owned foreign corporation to a U.S. shareholder of the foreign corporation or to a related party, whether U.S. or foreign. The 10-percent exception does not apply to inclusions under the subpart F and foreign personal holding company provisions since those provisions do not operate unless the foreign corporation earns threshold amounts of tax-haven type or passive income.

The application of the 10-percent exception may be illustrated as follows: Assume that a foreign corporation wholly owned by a U.S. corporation earns net income of $95 from the sale of inventory in a second foreign country. The foreign corporation also earns net dividend income (after allocation of expenses) of $5 from a U.S. corporation. All of the foreign corporation's $100 of net income is foreign base company income. Among the foreign corporation's expenses (deductions from gross income) is a $20 interest payment to its U.S. parent. The foreign corporation's $95 of net sales income is from foreign sources. Its $5 of net dividend income is from U.S. sources. Assume, for purposes of this example only, that earnings and profits equal net income and that $19 of the $20 interest payment was allocated to gross foreign sales income and the remaining $1 to gross U.S. dividend income in computing the respective amounts of net income from foreign and U.S. sources.

Under subpart F, the U.S. parent corporation must include the foreign corporation's $100 of foreign base company income in its gross income for the taxable year.

To determine whether the 10-percent exception may apply, the foreign corporation's earnings and profits are first recomputed without any reduction for the $20 interest payment to its U.S. parent. Earnings and profits recomputed in this manner equal $120. Of this amount, $6, or five percent, is attributable to U.S. sources (the $5 of net U.S. dividend income plus the $1 of the $20 interest payment previously allocated to gross U.S. dividend income in computing the amount of net income from U.S. sources).

While less than 10 percent of the foreign corporation's recomputed earnings and profits for the year are, thus, attributable to U.S. sources, the exception does not apply to subpart F income. Therefore, the portion of the U.S. corporation's $100 subpart F inclusion attributable to U.S. source taxable income of the foreign corporation ($5) is treated as U.S. source income of the U.S. parent.

The exception does, however, apply to interest payments. Because the foreign corporation's recomputed earnings and profits exceed zero and less than 10 percent of those recomputed earnings and profits is attributable to U.S. sources, the $20 interest payment made by the foreign corporation to its U.S. shareholder is not treated as U.S. source income under the provision.

Definitions and other rules

A foreign corporation is a "U.S.-owned foreign corporation" for purposes of the provision if 50 percent or more of either the total combined voting power of all classes of its voting stock or the total value of its stock is held directly or indirectly by U.S. persons. The Act specifies that, for purposes of the provision, the term "dividend" includes any gain treated as ordinary income under Code section 1246 or as a dividend under Code section 1248. The Act provides that the provision applies before the Code's foreign loss recapture rules (Code sec. 904(f)).

The Act requires the Secretary to prescribe such regulations as may be necessary or appropriate for application of the provision in the case of interest or dividend payments through one or more entities. For example, a U.S.-owned foreign corporation that earns gross U.S. source income but that pays interest to a related foreign party might thereby reduce the amount of income that would otherwise be subject to the provision. The Secretary is to prescribe rules so that an inclusion in income of a U.S. taxpayer on account of the related foreign corporation will be subject to the provision. Such an inclusion could occur, for example, under the rules of subpart F, on a dividend or interest payment by the related foreign corporation, or on an investment by the related foreign corporation in U.S. property.

Effective Date

General rule

The provision generally takes effect on the date of enactment. In the case of any taxable year of a U.S.-owned foreign corporation ending after the date of enactment, only income received or accrued by the U.S.-owned foreign corporation during that portion of the taxable year after the date of enactment generally is to be taken into account for purposes of the provision. However, *all* income received or accrued by the U.S.-owned foreign corporation during that taxable year is to be taken into account for purposes of applying the exception for corporations with small amounts of U.S. source income.

Transitional rules

Two transitional rules are provided. The purpose of these transitional rules is to retain prior tax treatment for taxpayers receiving distributions, etc. from corporations that borrowed pursuant to fixed-term arrangements before the Senate Committee on Finance took action on the legislation. Congress did not intend that any inferences be drawn from these transitional rules regarding the correct tax treatment, under prior law, of transactions involving international finance subsidiaries in the Netherlands Antilles.

Under the first transitional rule, certain interest received or accrued by "applicable CFCs" (controlled foreign corporations) is not taken into account for purposes of applying the provision if the interest is allocable to certain CFC obligations outstanding, or certain CFC equity, as of March 31, 1984. Interest received or accrued prior to 1992 on U.S. affiliate obligations held by an applicable CFC and attributable to that CFC's capitalization on March 31, 1984 qualifies for this treatment. For this purpose, an applicable CFC's capitalization on March 31, 1984 is equal to the sum of the CFC's obligations (issued by the CFC) and equity outstanding on March 31, 1984. Obligations outstanding on March 31, 1984 do not count for this purpose if they were not issued before March 8, 1984, unless a binding commitment by the CFC to issue them was in effect on March 7, 1984.

Qualified interest in a given taxable year is determined by multiplying the interest received or accrued in that year on an applicable CFC's loans to its U.S. affiliates by a limiting fraction. The limiting fraction is equal to (1) the aggregate principal amount of U.S. affiliate obligations held by the CFC on March 31, 1984 (but not in excess of the CFC's March 31, 1984 capitalization), divided by (2) the average daily principal amount of U.S. affiliate obligations held by the CFC during the taxable year. In no event may the limiting fraction exceed one.

The numerator of the limiting fraction is adjusted downward to reflect (1) retirements in that taxable year of any obligations issued by the CFC that are included in its March 31, 1984 capitalization, and (2) a pro rata portion of the CFC's equity allocable to these retired obligations.

For purposes of this transitional rule, the principal amount of CFC and U.S. affiliate obligations with OID includes, as of any day, the aggregate amount of all OID on such obligations previously includible in gross income as of that day. Proper adjustments are to be made in the numerator of the limiting fraction for OID accruing after March 31, 1984 on CFC obligations and U.S. affiliate obligations. The latter rule allows an upward adjustment in the numerator, where necessary, for OID accrued after March 31, 1984 on OID-type CFC obligations. However, to the extent that the proceeds of OID-type CFC obligations included in a CFC's March 31, 1984 capitalization were used, as of March 31, 1984, to finance non-U.S. affiliate obligations, no special adjustment in the numerator will be allowed under this rule.

An "applicable CFC" is any controlled foreign corporation in existence on March 31, 1984, the principal purpose of which on that date consisted of issuing CFC obligations or otherwise borrowing money and lending the proceeds to affiliates. A controlled foreign corporation satisfies this principal purpose test if at least half of its liabilities on March 31, 1984 were CFC obligations and if at least half of its assets on that date were loans to affiliates.

An "affiliate" is any person related (within the meaning of Code section 482) to an applicable CFC. A "U.S. affiliate" is any U.S. person which is an affiliate of an applicable CFC. A "U.S. affiliate obligation" is any obligation of (and payable by) a U.S. affiliate.

A "CFC obligation" generally is any obligation of (and issued by) a CFC for which there are arrangements reasonably designed to ensure that the obligation will be sold (or resold in connection with the original issue) only to foreign persons (sec. 163(f)(2)(B)(i)). In the case of an obligation issued after December 31, 1982 that is not in registered form, the obligation must also, to qualify as a CFC obligation, bear interest payable outside the United States only and indicate that U.S. holders are subject to tax penalties (sec. 163(f)(2)(B)(ii)).

The first transitional rule does not apply in determining whether the exception for corporations with small proportional amounts of U.S. source income applies. Thus, if an applicable CFC has $100 of earnings and profits for a given year, $15 of which is attributable to qualified interest, $5 of which is attributable to other U.S. source income, and $80 of which is attributable to foreign source income, the exception does not apply for that year: For purposes of the exception, 20 percent of the applicable CFC's earnings and profits are attributable to U.S. sources. However, because, under the transitional rule, qualified interest is not otherwise taken into account for purposes of the provision, only 5/100ths (rather 20/100ths) of a dividend paid by the applicable CFC out of that year's earnings and profits is subject to the provision.

Under the second transitional rule, which does not apply if the first transitional rule applies, interest earned on term obligations held on March 7, 1984 by foreign corporations is not taken into account for purposes of the provision. Also, interest earned on term obligations of U.S. persons other than U.S. affiliates that are held by applicable CFCs on March 7, 1984 is not taken into account.

The Act provides that the foreign tax credit limitation generally will be computed separately (as it is for certain interest income, for example) for income derived from a U.S.-owned foreign corporation that benefits from either of the two transitional rules, i.e., is not treated as U.S. source income under the provision. Thus, foreign taxes paid by the recipient of such income on other income are not creditable against the U.S. tax on the income that benefits from either transitional rule. This rule does not apply in particular limited circumstances to certain income received or accrued before January 1, 1986.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $13 million in 1984, $60 million in 1985, $64 million in 1986, $70 million in 1987, $76 million in 1988, and $82 million in 1989.

2. Maintaining the Character of Interest Income (sec. 122 of the Act and sec. 904 of the Code)[3]

Prior Law

In general, the United States taxes U.S. corporations on their worldwide income, but grants a credit for foreign income taxes paid or accrued. The credit is limited to ensure that foreign taxes can offset only U.S. tax on foreign source taxable income. The limitation is determined by using a simple ratio of foreign source taxable income to worldwide taxable income. The limitation is computed on a worldwide or overall basis so that taxes paid to one foreign country in excess of the U.S. rate can offset U.S. tax that would be imposed on other low-taxed or untaxed foreign income.

A credit is also permitted for certain taxes paid by foreign corporations whose voting stock is owned at least 10 percent by a U.S. corporation (Code sec. 902). Dividends to such U.S. corporations carry with them a proportionate amount of the foreign taxes paid by the foreign corporation.

In general, taxes paid on one kind of foreign source income in excess of the U.S. rate can offset U.S. tax that would be imposed on other kinds of low-taxed or untaxed foreign source income. However, this general rule does not apply to certain interest. Many foreign countries do not tax interest that their residents pay to U.S. lenders—including interest that their banks pay to U.S. depositors. Therefore, frequently, U.S. persons can earn foreign interest income free of foreign tax. A separate foreign tax credit limitation for certain interest income provides that if a U.S. person pays no foreign tax on foreign interest income, the U.S. person generally must pay U.S. tax on that foreign interest income. This rule preserves the U.S. tax on untaxed interest income of U.S. persons, wherever earned, and prevents the creation of a tax advantage for taxpayers who invest outside the United States. Its primary purpose is to prevent generation of low-taxed foreign source interest income that can absorb excess foreign tax credits. Because of the separate foreign tax credit limitation for interest income, foreign taxes on non-interest income generally will not offset the U.S. tax on foreign interest income, no matter how high the foreign taxes on foreign non-interest income.[4] Interest income to which the sepa-

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[3] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 142; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1349-50; House floor amendment, 130 Cong. Rec. H2738 (April 11, 1984); "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 129; S. Prt. No. 98-169, Vol. I (April 2, 1984), pp. 391-94; H. Rep. No. 98-861 (June 23, 1984), pp. 925-30 (Conference Report); and H. Con. Res. 328, 130 Cong. Rec. S8944 (June 29, 1984), H7526 (June 29, 1984).

[4] Similarly, foreign taxes on foreign interest income generally cannot offset U.S. tax on foreign non-interest income. In general, the total (U.S. and foreign) tax on a U.S. person's foreign interest income is the higher of the U.S. tax or the foreign tax on foreign interest.

rate limitation applies does not include interest derived from a transaction that is directly related to the active conduct by the taxpayer of a trade or business in a foreign country or U.S. possession (or derived from disposition of such a trade or business), interest derived in the conduct by the taxpayer of a banking, financing, or similar business, interest received from 10-percent owned corporations, or interest received on disposition of certain securities in 10-percent owned corporations.

Under prior law, taxpayers could circumvent the separate foreign tax credit limitation for interest income. Instead of lending money and earning interest income directly, a U.S. person could own all or part of a foreign corporation that lent money (for example, through a bank deposit) and earned interest income. The use of the foreign corporation could convert the character of the interest income to non-interest income, for example, dividend income. (Such dividend income ordinarily would be foreign source income under prior law, notwithstanding that it might derive from U.S. source interest income.) The conversion might have removed the income from the separate foreign tax credit limitation and allowed it to absorb foreign tax credits attributable to non-interest income. This recharacterized "non-interest" income could escape all U.S. and foreign tax.

As another example, a U.S. person could invest in a regulated investment company (RIC) that bought foreign interest-bearing investments. There might have been little or no foreign tax on the income from these investments. The RIC's dividends might have been foreign income under a special rule that recharacterizes payments from a U.S. corporation as foreign if 80 percent or more of its income is foreign. These dividends might have absorbed excess foreign tax credits and thus escaped U.S. tax.

Reasons for Change

The separate foreign tax credit limitation for interest was enacted (in 1962) to prevent taxpayers from converting U.S. source income to foreign source low-taxed interest income and thus inflating the foreign tax credit limitation.

It came to the attention of Congress, however, that taxpayers could continue to achieve this result by having interest paid to a foreign subsidiary rather than directly to the taxpayer and then having the interest distributed as a dividend. As a result of an easily manipulable financial transaction, then, an inflation of the foreign tax credit limitation was possible. In the changes made by the Act, Congress sought to insure the integrity of the separate foreign tax credit limitation for interest income, and to prevent U.S. taxpayers with foreign subsidiaries from using these subsidiaries to convert interest income into non-interest income.

Prior law, by encouraging U.S. taxpayers to invest capital outside the United States, eroded the U.S. tax base. If permitted to convert low-taxed foreign interest income to non-interest income, taxpayers could circumvent the foreign tax credit limitation. Then, the U.S. Treasury, and not the U.S. taxpayer, bore the burden of foreign taxes on non-interest income.

Explanation of Provision

General rule

In general, the Act subjects income of a U.S. person that is attributable to separate limitation interest income (Code sec. 904(d)(2)) of a regulated investment company (RIC) or certain foreign corporations to the separate foreign tax credit limitation for interest.

The Act treats dividends and interest that are paid or accrued by a designated payor corporation (and attributable to any taxable year of such a designated payor corporation) as interest income subject to the separate foreign tax credit limitation for interest to the extent that the aggregate amount of such dividends and interest does not exceed the separate limitation interest of the designated payor corporation for the taxable year. This rule applies for purposes of the foreign tax credit limitation only. A dividend, for these purposes, includes any subpart F (Code sec. 951) or foreign personal holding company inclusion (sec. 551) and any gain treated as ordinary income under section 1246 or as a dividend under Code section 1248.

Computation of foreign corporation's separate limitation interest

The Act defines the term "separate limitation interest" to mean, with respect to any taxable year, the aggregate amount of the interest income of the type that is subject to the separate limitation which is received or accrued by the designated payor corporation during the taxable year (sec. 904(d)(2)), reduced by the sum of any deductions properly allocable (under regulations prescribed by the Secretary) to such income. For this purpose, the only deductions properly allocable against gross interest income (other than deductions definitely related to gross interest income) are interest deductions. The allocation of interest deductions (that cannot be allocated to specific property) may generally occur under any proper method, but Congress intended that the same allocation method apply for all purposes for any particular year. Congress did not intend, however, to limit the Internal Revenue Service's general authority to disallow use of any allocation method where the taxpayer engages in transactions designed to increase its net income subject to the separate foreign tax credit limitation for interest income, as computed using that allocation method.

Because interest earned in the conduct of a banking, financing, or similar business, for example, is not interest income of the type subject to the separate limitation (sec. 904(d)(2)(B)), a dividend from a U.S.-owned foreign corporation is not separate limitation interest to the extent attributable to earnings and profits from such a business.

Consistent with the preexisting Code rules for determining whether interest income is subject to the separate foreign tax credit limitation for interest (sec. 904(d)(2)), interest received by a foreign corporation from a related party described in Code section 1504 generally is not treated as separate limitation interest of the foreign corporation. Conversely, the Act provides that interest received or accrued by a designated payor corporation from any related party described in section 1504 (whether or not a foreign person) *is* treated as separate limitation interest under the provision to the extent that the related payor earns (directly or indirectly) income that is separate limitation interest or that is attributable to separate limitation interest.

The computation of a foreign corporation's separate limitation interest may be illustrated as follows: Assume that a foreign corporation wholly owned by a U.S. corporation owns assets with a total tax book value of $500, consisting of a $150 loan to its wholly owned (2d-tier) foreign subsidiary, a $100 loan to an unrelated party, and active business assets worth $250. It earns $100 of gross income, consisting of $25 of gross interest on the loan to its wholly owned foreign subsidiary, $15 of gross interest (not related to its active business) on the loan to the unrelated party, and $60 of gross income from its active business. (The second-tier foreign subsidiary is incorporated in a different foreign country from the foreign corporation and is engaged solely in active business; that is, it earns no separate limitation interest itself.) The foreign corporation pays $15 of interest to an unrelated party. It incurs $50 of other expenses in connection with its active business. Its net income is $35. It pays no dividend out of this income.

The $15 of gross interest on the loan to the unrelated party in this example is interest described in Code section 904(d)(2), so that it is subject to the provision. To determine that portion of this interest that is separate limitation interest for purposes of the provision, properly allocable expenses reduce the gross interest. In determining separate limitation interest in this example, the $15 of interest that the foreign corporation paid to an unrelated party is a properly allocable expense. The taxpayer uses the asset method of allocation for the year. Thus, it allocates $3 ($15x($100/$500)) against its $15 of gross interest income on the loan to the unrelated party. The Act therefore treats $12 ($15—$3) of the income of the foreign corporation as separate limitation interest.

Definition of designated payor corporation

The Act defines the term "designated payor corporation" to mean (1) any foreign corporation if 50 percent or more of either the total combined voting power of all classes of its voting stock or the total value of its stock is held directly or indirectly by U.S. persons; (2) any other foreign corporation in which a U.S. person is a U.S. shareholder (a U.S. person who owns directly, indirectly, or constructively 10 percent or more of the total combined voting power of all classes of stock entitled to vote of the foreign corporation) at any time during the taxable year of such foreign corporation; or (3) any regulated investment company (RIC). Category (2) includes any foreign corporation with a 10-percent U.S. shareholder whether or not the foreign corporation is a controlled foreign corporation. Congress included foreign corporations with 10-percent U.S. shareholders within the scope of the rule because of a concern that U.S. taxpayers were structuring their affairs to avoid 50-percent U.S. ownership.[5]

[5] It has come to the attention of the staff that some taxpayers argue that it may be possible to circumvent the intent of the statute, as presently drafted, by structuring transactions to avoid

Continued

Ten-percent exception

In general, the new provision maintaining the character of interest income does not apply to amounts attributable to the taxable year of a designated payor corporation if the designated payor corporation has earnings and profits for that taxable year, and if less than 10 percent of those earnings and profits is attributable to separate limitation interest. Like the corresponding 10-percent exception to the new rules maintaining the source of U.S. source income (sec. 904(g), as amended by sec. 121 of the Act), this exception was not intended to apply to subpart F and foreign personal holding company inclusions. Such inclusions attributable to the taxable year of a designated payor corporation are already subject to de minimis exceptions: no inclusions are required absent threshold amounts of tax-haven type or passive income. A technical correction will be necessary to clarify this point.

Interest payments to related persons

Interest that a designated payor corporation pays or accrues to any of its U.S. shareholders (a U.S. person who owns or who is considered to own 10 percent or more of its voting power) or to a person related to any of its U.S. shareholders does not reduce separate limitation interest of the designated payor corporation, for the purpose of determining the amount of the designated payor corporation's separate limitation interest that is subject to the provision for the year. Such interest does not reduce earnings and profits or separate limitation interest for the purpose of the exception that applies to designated payor corporations with earnings and profits less than 10 percent of which is attributable to separate limitation interest. However, Congress intended that such paid or accrued interest, once taken into account for U.S. tax purposes as interest income subject to the separate foreign tax credit limitation for interest, not result in double counting of income subject to the separate limitation.

Ordering and related rules

The Act treats inclusions with respect to, and amounts paid by, a designated payor corporation as first attributable to passive interest under the theory that it would be as easy for the ultimate interest recipient to have received the separate limitation interest directly as to have channeled it through a designated payor corporation. In addition, this "stacking" of interest prevents avoidance of tax through the use of back to back loans.

The order in which the Act treats amounts attributable to separate limitation interest as income subject to the separate foreign tax credit limitation for interest is as follows. It first treats subpart F and foreign personal holding company inclusions on account of a designated payor corporation as income subject to the separate foreign tax credit limitation for interest up to the amount of the separate limitation interest of the designated payor corporation. If the inclusions so treated are less than the separate limitation interest

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these U.S. ownership requirements. While regulations may be able to treat some or all of these transactions in a way consistent with congressional intent, statutory amendments to eliminate any doubt about this issue may be suggested to the committees.

of the designated payor, then interest paid or accrued by the designated payor corporation is treated as income subject to the separate foreign tax credit limitation for interest. If the interest so treated plus the inclusions previously so treated are less than the separate limitation interest of the designated payor corporation, then any dividend paid out of the earnings and profits of the designated payor corporation for the taxable year is treated as income subject to the separate foreign tax credit limitation for interest.

The application of the ordering provision is illustrated in the following examples: Assume that a designated payor corporation earns $150 of gross active business income during a year and incurs $125 of expenses directly related to that active business. In that year, it also earns $15 of separate limitation interest. There is no subpart F inclusion in the income of its U.S. shareholders with respect to that year because the foreign corporation's gross base company income ($15) is less than 10 percent of its gross income ($165). The foreign corporation incurs no interest expense or foreign tax during the year. Its earnings and profits ($40) consist of $25 of active business income and the $15 of separate limitation interest. It pays a dividend with respect to the earnings and profits of the year of $16. The Act treats the dividend as coming first out of separate limitation interest, so that $15 of the dividend is income subject to the separate foreign tax credit limitation for interest income, while $1 is not subject to the separate foreign tax credit limitation. Any later dividend with respect to that year's earnings will not be subject to the separate foreign tax credit limitation, as the $16 dividend has exhausted the pool of separate limitation interest for that year.

As another example, assume that a designated payor corporation that is also a controlled foreign corporation earns $100 of net income during a year. Twenty dollars of this income is separate limitation interest. Among the foreign corporation's expenses is a $30 interest payment to its U.S. parent. All of the foreign corporation's $100 of net income is foreign base company income. Therefore, under the subpart F rules, its U.S. parent must include the entire $100 in its income for the year. The U.S. parent treats $20 of this subpart F inclusion as income subject to the separate foreign tax credit limitation for interest income. The $30 interest payment by the designated payor corporation to its U.S. parent is not income subject to the separate foreign tax credit limitation for interest income because the full $20 of the designated payor corporation's separate limitation interest has already been used in characterizing the subpart F inclusion.

The Act specifies rules for treating amounts included in U.S. taxable income as attributable to the taxable year of a designated payor corporation. Subpart F and foreign personal holding company inclusions with respect to a designated payor corporation are attributable to the year of inclusion; interest paid or accrued by a designated payor corporation is attributable to the year that the designated payor corporation pays or accrues it; and dividends from a designated payor corporation are attributable to the year out of whose earnings and profits they are paid.

Deemed paid credit and creditability of foreign taxes

Dividends and subpart F inclusions treated as interest under the provision for the purpose of the foreign tax credit limitation retain their character as dividends and subpart F inclusions for the purpose of determining whether the taxpayer is entitled to a deemed-paid foreign tax credit (secs. 902 and 960). However, the deemed paid taxes attributable to income treated as separate limitation interest are treated as taxes on separate limitation interest. In addition, any taxes deemed paid on such dividends and subpart F inclusions and treated as dividends for the purpose of the deemed-paid credit "gross-up" (sec. 78) are characterized in accordance with the income with respect to which the taxes were paid.

Foreign taxes on interest whose character as such is maintained under this provision will be creditable taxes if they meet the Code's standards for creditability. For example, foreign taxes on U.S. source interest that is earned by a designated payor corporation and that (after a dividend or a subpart F inclusion) is considered U.S. source income in the hands of a U.S. person under section 121 of the Act (new Code sec. 904(g))—if they are creditable taxes—may be credited subject to the application of the taxpayer's foreign tax credit limitation for interest income.

Payments through one or more entities

The Secretary is to prescribe regulations for the application of the provision in cases of distributions or payments made through one or more entities. For example, a designated payor corporation that earns separate limitation interest might pay interest to a related foreign party. That interest payment might reduce the amount of income currently subject to treatment as separate limitation interest in the hands of the designated payor corporation's U.S. owners. The income of the recipient of the interest (the related foreign corporation) might not be subject to U.S. tax, so the Act's restriction of the foreign tax credit limitation might not affect the related foreign person. The Secretary is to prescribe rules so that an inclusion in income of a U.S. taxpayer on account of the related foreign corporation will be subject to treatment as interest subject to the separate foreign tax credit limitation for interest. Such an inclusion could occur, for example, under the rules of subpart F, on a dividend or interest payment by the related foreign corporation, or on an investment by the related foreign corporation in U.S. property.

The following example further illustrates the intent of Congress and indicates how the regulations would apply: Assume that a controlled foreign corporation ("CFC-1") earns $100 of gross separate limitation interest (that would be foreign personal holding company income subject to subpart F) but reduces its current year earnings and profits to zero by a $100 interest payment to a related foreign party ("CFC-2"). Therefore, there is no subpart F inclusion for the year on account of CFC-1. If there were no subpart F inclusion on account of CFC-2 (for instance, because foreign base company income made up less than 10 percent of the gross income of CFC-2), later dividends from CFC-2 would be treated as interest subject to the separate limitation, whether or not 10 percent of the earnings and profits of CFC-2 for the year at issue were attributable to the separate limitation interest that it received from CFC-1 or to other separate limitation interest.

Interaction with rules maintaining source of income

Along with this provision that maintains the character of interest income that passes through foreign corporations, the Act contains a provision (sec. 121 of the Act) that maintains the source of U.S. source income that passes through foreign corporations. Under the Act, any particular item of income will retain both its source and its character as it flows through a foreign corporation.

The following example illustrates the interaction of the Act's rules maintaining the source and the character of income: Assume that a wholly owned foreign subsidiary of a U.S. corporation earns $105 of net income, and that its net income equals its gross income. Its income consists of $25 of U.S. source royalty income from a license to a related U.S. person, $5 of interest on a loan to a U.S. affiliate, $10 of interest on a loan to an unrelated U.S. party, $15 of interest on a loan to a foreign affiliate, $20 of interest on a loan to an unrelated foreign party, and a $30 dividend from a foreign corporation incorporated outside the subsidiary's country. None of its income is effectively connected with a U.S. trade or business.

Assume that the U.S. parent includes all the subsidiary's $105 of earnings in income under subpart F. It treats $45 (the $30 dividend and the $15 interest on the foreign related party loan) as foreign source income not subject to the separate foreign tax credit limitation for interest. It treats $30 (the $25 royalty and the $5 related party interest payment) as U.S. source income not subject to the separate foreign tax credit limitation for interest. It treats the $20 of interest on the foreign unrelated party loan as foreign source income subject to the separate foreign tax credit limitation for interest. It treats the $10 of interest on the U.S. unrelated party loan as U.S. source income subject to the separate foreign tax credit limitation for interest. Therefore, any foreign taxes imposed on this $10 of interest income will be allowable as foreign tax credits only to the extent of the separate foreign tax credit limitation for interest.

Effective Date

The provision generally takes effect on July 18, 1984, the date of enactment. Generally, only interest income received or accrued by a designated payor corporation in taxable years beginning after that date retains its character as it flows through the designated payor corporation. However, *all* interest income earned by a designated payor corporation with respect to investments by a taxpayer in the designated payor corporation after June 22, 1984, the date of conference action, retains its character as it flows through to the taxpayers making post-June 22 investments. By contrast, during the transition period (generally the taxable year including July 18, 1984), interest income attributable to pre-June 23, 1984, investments does not retain its character by virtue of the provision. In the case of a designated payor corporation that is not an applicable CFC (as defined in section 121(b)(2)(D) of the Act), the provision does not apply to any interest that the corporation receives or accrues on a term obligation that it held on March 7, 1984.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $67 million in 1985, $118 million in 1986, $129 million in 1987, $142 million in 1988, and $157 million in 1989.

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3. Related Person Factoring Income (sec. 123 of the Act and secs. 864 and 956 of the Code)[6]

Prior Law

When a seller of goods or services takes back a receivable (a promise to pay in the future) in exchange therefor, and then sells the receivable to a third party (a "factor") at a discount, the seller's income on the sale of the goods or services is reduced by the amount of that discount, and upon payment of the obligation, the factor realizes income equal to the difference between the amount the factor paid for the receivable and the amount received when the receivable is collected.

The Tax Court, in *Elk Discount Corp.* v. *Commissioner,* 4 T.C. 196 (1944), held that the discount, or factoring, income earned by an active factoring business is not interest within the definition of personal holding company income. In that case, both the seller of the receivable and the factor were U.S. corporations doing business in the United States. A number of issues arose under prior law as to the tax treatment of a factoring transaction when the factor was a controlled foreign corporation related to the seller. Arguably, the factoring income could have been foreign base company income that was currently taxable to the foreign corporation's U.S. shareholders under the anti-tax haven activity rules of subpart F as interest or as income from the performance of services for a related party. These rules also provide, in general, that if foreign base company income is less than 10 percent of gross income of a controlled foreign corporation, no part of its gross income is treated as foreign base company income; in general, if foreign base company income is more than 70 percent of gross income of a controlled foreign corporation, all its gross income is treated as foreign base company income. However, the Internal Revenue Service held in one instance that factoring income was not interest for purposes of subpart F (private letter ruling 8338043, June 17, 1983).

A loan from a controlled foreign corporation to a related U.S. person is generally treated as an investment in U.S. property under section 956, with the result that the amount of the loan is treated as constructive distribution from the controlled foreign corporation to its U.S. shareholders and is taxable to the U.S. shareholders to the extent of the earnings and profits of the controlled foreign corporation. Similarly, certain indirect loans from con-

[6] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 131; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1304-1306; House floor amendment, 130 Cong. Rec. H. 2738 (April 11, 1984); "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 121; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 347-351; H. Rep. No. 98-861 (June 23, 1984), pp. 930-933 (Conference Report); and H. Con. Res. 328, 130 Cong. Rec. S. 8944 (June 29, 1984), H. 7526 (June 29, 1984).

trolled foreign corporations to related U.S. persons are treated as investments in U.S. property (Rev. Rul. 76-192, 1976-1 C.B. 205). The purchase of a receivable of a U.S. person from a related U.S. corporation could arguably have been treated as an investment in U.S. property in certain cases. In that event, the amount paid for the receivable would have been treated as a constructive distribution from the controlled foreign corporation to its U.S. shareholders and would have been taxable to the U.S. shareholders to the extent of the earnings and profits of the controlled foreign corporation.

In some cases, it might be argued that a foreign corporation factoring U.S. receivables is engaged in business in the United States, and that its factoring income is, therefore, subject to U.S. tax.

In certain cases, if the bulk of a taxpayer's income is derived from the active conduct of a trade or business in a U.S. possession, and if the bulk of the taxpayer's income arises within a U.S. possession, favorable U.S. tax rules apply. For example, in the case of a U.S. corporation, foreign source business income earned in the possessions generally (most notably Puerto Rico) may be effectively exempt from U.S. tax under the possession tax credit (sec. 936). Similarly, in the case of a Virgin Islands corporation or a U.S. corporate inhabitant of the Virgin Islands, the United States may impose no tax on its income, and the Virgin Islands may reduce its tax on the corporation's income (sec. 934(b)). Under prior law, it was not clear if income from factoring was derived from the active conduct of a trade or business for the purpose of these rules.

Under prior law, it was unclear whether the source of factoring income for tax purposes was where the factor had its place of business, where the obligor of the receivable resided or did business, or where the seller of the receivable resided or did business. If income from factoring constituted income from the active conduct of a trade or business at the place where the factor did business, and if income from factoring arose at the place where the factor did business, income from a factoring business in a U.S. possession may have been eligible for these favorable tax rules.

Reasons for Change

In most respects, a factoring transaction is a financing transaction in which the factor has assumed a loan to the obligor on the account receivable and the discount earned by the factor is functionally the equivalent of interest. By structuring the transaction as the factoring of a receivable rather than as a loan, however, the parties could significantly alter the tax consequences of the transaction and, in particular, could plan around certain anti-abuse rules of prior law.

The purpose of subpart F of the Code and of the foreign personal holding company rules is to prevent the shifting of earnings to a jurisdiction having no natural business nexus with the income and where the income will be taxed at a low rate, if at all. These rules tend to enforce the principle of capital export neutrality. Otherwise, there would be an incentive to shift investment earnings to countries with low effective tax rates and away from the United States. Factoring income is financing income that easily can be shifted from one country to another even where the country in which the income is finally earned has no economic nexus with the underlying transaction. In cases in which the factored receivable arises from a sale by a U.S. taxpayer, the U.S. tax base has been directly reduced, and the U.S. tax has not been replaced by a foreign tax paid in a natural business locus in which the income arises. Accordingly, a tax incentive exists to maximize the income from factoring in a tax haven. In addition, there is the further opportunity to accumulate earnings in the country to which the income has been shifted.

Although not as direct, the same concern is present when the factoring transaction involves a receivable that arises from the sale of goods or services by a foreign corporation to a related or unrelated foreign or U.S. person. The factoring transaction again transfers a portion of the profit to a country that may have no natural business nexus with the underlying income. If the factoring income is not taxed in the country in which earned, the resulting overall reduction in foreign tax on the combined transaction in effect increases the after-tax return on the foreign investment in the overseas manufacturing or service business (possibly below that of the United States). This could make foreign investment preferable to U.S. investment.

Taxpayers may also have sought to use factoring transactions to circumvent the provision of present and prior law that treats investment in U.S. property as a distribution of foreign earnings. To permit these factoring transactions to occur tax-free would permit the tax-free repatriation of low-taxed foreign earnings. Specifically, Congress believed that when a receivable of a U.S. person is acquired directly or indirectly from a related U.S. person, this combination of effective repatriation and U.S. nexus should subject this transaction to tax to the extent of untaxed earnings and profits. Not only does this transaction makes funds available for use by U.S. shareholders, it is in substance a wholly domestic transaction.

Finally, Congress intended to make it clear that taxpayers cannot avoid tax on factoring income by using entities organized in the U.S. possessions.

Explanation of Provision

The Act treats any income (whether in the form of discount, stated interest, or some other form) arising from a trade or service receivable (defined below) acquired directly or indirectly by a foreign corporation from a related person as if it were interest on a loan to the obligor under the receivable. The related person may be either a foreign person or a United States person. This rule applies only for purposes of the foreign personal holding company rules, the Subpart F rules, and the foreign tax credit limitation. In applying this rule, the source rules (secs. 861-863) apply as though the income from a trade or service receivable were interest on a loan to the obligor under the receivable.

A trade or service receivable is defined as an account receivable or other evidence of indebtedness initially arising out of either the disposition of property described in section 1221(1) (generally inventory or property held by the taxpayer primarily for sale to customers in the ordinary course of trade or business), or the performance of services, by a person who is related to the person who earns income from the satisfaction or disposition of the receivable or evidence of indebtedness. The term, however, does not encompass a receivable or evidence of indebtedness arising out of the disposition of property or the performance of services by a person not related to the person realizing income from the receivable or evidence of indebtedness. Assume, for example, that a hotel accepts an evidence of indebtedness having a face amount of $100 from a customer in payment for services. The hotel transfers such evidence of indebtedness at a discount ($95) to an unrelated person (for example, a company whose trade or business consists of factoring evidences of indebtedness for unrelated persons). The evidence of indebtedness is not a "trade or service receivable" in the hands of the unrelated person or a transferee from the unrelated person since the evidence of indebtedness initially arose out of the performance of services by the hotel rather than by a person related to the ultimate holder of the receivable. If, however, the hotel and the factoring company were related, the receivable would be a "trade or service receivable" within the meaning of the Act.

The application of the rule treating related person factoring income as interest income also will apply to determine the source of that income upon eventual inclusion of the income in the gross income of a U.S. person pursuant to the provision of the Act that maintains the source of U.S.-source income that flows through a foreign corporation (sec. 121 of the Act, Code sec. 904(g)). If the obligor under a receivable is a U.S. person, the factoring income will be U.S. source income upon inclusion in the gross income of a U.S. shareholder of the foreign corporation (unless the obligor pays foreign source income under the "80/20" rule (sec. 861(a)(1)(B)).

The Act does not address the question whether a foreign corporation earning income from a trade or service receivable of a U.S. obligor will be taxable currently on that income if it is not effectively connected with a U.S. trade or business (under Code sec. 881). In addition, the Act does not allow, for example, the obligor under a receivable to treat any part of the purchase price of a capital asset as deductible interest, even though the seller of the asset and parties related to the seller treat some of the obligor's payments as interest.

Income from a receivable is subject to the rules of the Act whenever the receivable or an interest in the receivable is assigned to a foreign corporation by a related party. There will be an acquisition of a receivable, for the purpose of the rule contained in the Act, whether or not the person earning the income from the receivable takes title to or physical possession of the receivable, and whether the related party that transfers the rights to income from a receivable does so with or without recourse.

The Act defines "related party" broadly to include not only related parties as defined for the purpose of the loss disallowance or deferral rule of section 267 but also 10-percent U.S. shareholders and persons related to 10-percent U.S. shareholders. This broad related party rule prevents tax-free related-person factoring by foreign corporations owned by several U.S. persons.

Related person factoring income under the Act is treated as interest described in section 904(d)(2), and therefore subject to the separate foreign tax credit limitation for interest. The income is ineligible for any exception to application of the separate limitation. Congress adopted this treatment so that foreign tax credits on non-interest non-factoring income cannot offset U.S. tax on related person factoring income. Taxpayers can generally arrange to earn factoring income, like other financial income, in tax havens, and the Congress believed that it is appropriate to collect the full U.S. tax, unreduced by foreign tax credits on unrelated income, on factoring income.

Congress intended to subject related person factoring income to tax if that income is earned by any controlled foreign corporation with earnings and profits. Therefore, related person factoring income does not benefit from exceptions to the Subpart F rules. The income will be taxed to the U.S. shareholders without regard to the general 10-percent de minimis exception from foreign base company income. Factoring income will nonetheless count as subpart F income in determining whether 10 percent or 70 percent of gross income is subpart F income, so that, for example, a controlled foreign corporation 9 percent of whose gross income is factoring income and 9 percent of whose gross income is foreign base company services income will be subject to Subpart F on the services income as well as the factoring income. In addition, factoring income does not benefit from any banking and financing exceptions (sec. 954(c)(3)(B) or sec. 954(c)(4)(B)) or from the same country interest (and dividend) exception (sec. 954(c)(4)(A)).

The Act also treats a loan by a controlled foreign corporation for the purpose of financing the purchase of goods or services of a related party like the acquisition by the foreign corporation of the purchaser's receivable. Congress included this rule in the Act to prevent taxpayers from restructuring transactions to avoid the intent of the factoring rule. Thus, income from such loans will be Subpart F income without regard to the exceptions for which factoring income is ineligible, and it will be subject to the separate foreign tax credit limitation for interest.

The Act provides that the possessions tax credit (sec. 936, whose prime beneficiary is Puerto Rico) and rules allowing the U.S. Virgin Islands to reduce its tax rate on certain income (sec. 934) do not apply to factoring income unless the income from the receivable arises within the possession under the rule that treats the income as income from a loan to the obligor of the receivable.

In addition, the Act treats certain factoring transactions as though they were loans from a controlled foreign corporation to a related U.S. shareholder. The Act amends the definition of U.S. property (in sec. 956) to include any trade or service receivable that is the obligation of a U.S. person and that is generated by a related U.S. person's disposition of inventory or performance of services. Therefore, the U.S. shareholders of a controlled foreign corporation are currently taxable on the amount that is paid for factoring such a trade or service receivable (up to the amount of the controlled foreign corporation's earnings and profits). Congress intended that this rule apply whatever the term of the obligation, and did not intend the short-term loan exception of Treas. Reg. sec. 1.956-2(d)(2) to frustrate the purpose of the rule.

Congress did not intend that taxpayers circumvent the investment in U.S. property rule of the Act by (1) directly or indirectly transferring assets representing earnings and profits from one foreign subsidiary to another foreign subsidiary, and (2) having the transferee invest those earnings and profits in U.S. property. Congress recognized that present and prior law imposes tax on the investment in U.S. property in the case of such a transfer, whether the transferor foreign corporation makes a direct or indirect loan to the transferee (Rev. Rul. 76-192, 1976-1 C.B. 205) or otherwise shifts assets representing earnings and profits to the transferee (such as by a contribution to the capital of a newly formed subsidiary with no earnings and profits).

If a controlled foreign corporation derives earnings and profits that are subject to U.S. tax on the ground that they are effectively connected with a U.S. trade or business, an amount of its assets equal to those earnings and profits is generally exempt from the investment in U.S. property rule (sec. 956(b)(2)(H)). Congress intended that this general rule apply in the case of earnings and profits derived from factoring receivables of related parties; a technical correction will be necessary to clarify this point.

The Act requires Treasury to prescribe regulations to prevent the avoidance of the provision's income inclusion rule and its investment in U.S. property rule. For example, for the purpose of this provision, Congress intended that the substitution of any party for the obligor be disregarded. Thus, if a U.S. purchaser of goods pays for the goods by establishing a line of credit with a foreign bank whose note the seller of the goods takes and sells at a discount to its foreign subsidiary, the income from the bank's obligation in the hands of the foreign subsidiary will be U.S. source income, and the acquisition of the bank's obligation will constitute an investment in U.S. property. Similarly, if a group of taxpayers arranges (directly or indirectly) to swap receivables so that each U.S. corporation's foreign subsidiary acquires receivables of other taxpayers in the group, Congress intended that regulations treat these transactions as subject to the factoring rules.

Effective Date

This provision generally applies to accounts receivable and evidences of indebtedness transferred after March 1, 1984, in taxable years ending after such date. However, a special transitional rule applies to certain accounts receivable held by a certain type of Belgian financing entity.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $306 million in 1985, $534 million in 1986, $576 million in 1987, $622 million in 1988, and $673 million in 1989.

4. Source of Transportation Income (sec. 124 of the Act and sec. 863 of the Code)[7]

Prior Law and Background

U.S. taxation of U.S. persons

The United States generally taxes the worldwide income of U.S. persons,[8] but a dollar-for-dollar credit for foreign income taxes is allowed so that the same income will not be subject to double tax by the United States and a foreign government.[9] The credit is limited so that it cannot reduce U.S. tax on U.S. income, i.e., it cannot exceed the amount of pre-credit U.S. tax on foreign income (foreign tax credit limitation).

The foreign tax credit limitation applies on an overall basis to most taxpayers: taxpayers combine income and losses from all foreign operations in all locations outside the United States to determine their foreign tax credit limitations. This allows taxpayers effectively to credit foreign income taxes paid on income from one foreign country against U.S. tax on income from other foreign sources, so long as total income characterized as from foreign sources is high enough. In some cases, taxpayers can effectively credit foreign income taxes imposed on U.S. source income, because the taxpayers have enough income characterized as from foreign sources.

U.S. taxation of foreign persons

In general, the United States taxes foreign corporations and nonresident alien individuals on their U.S. source income and on foreign source income that is effectively connected with the conduct of a U.S. trade or business carried on by the foreigner. Income that is effectively connected with a U.S. trade or business generally is taxed in the same manner and at the same rates to foreign persons as to U.S. persons.

Source of income generally

The Code provides rules for determining whether income is from U.S. sources or from foreign sources. U.S. source income generally includes, for example, income from sales of property manufactured in the United States and sold in the United States, income from services performed in the United States, and dividends and interest

[7] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 136; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1337-41; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 125; S. Prt. No. 98-169, Vol. I (April 2, 1984), pp. 379-82; and H. Rep. No. 98-861 (June 23, 1984), pp. 933-35 (Conference Report).

[8] U.S. persons are U.S. citizens, U.S. residents, U.S. partnerships, U.S. corporations, and, generally, U.S. trusts and estates (Code sec. 7701(a)(30)).

[9] Foreign income taxes include income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country (or possession of the United States).

paid by U.S. persons and certain foreign persons (sec. 861). Foreign source income includes income from the sale outside the United States of property manufactured outside the United States, income from services performed outside the United States, dividends and interest paid by other than U.S. persons (with certain exceptions), and royalties from the use outside the United States of patents, secret processes, and similar properties (sec. 862). Some income generally is treated as partially U.S. source and partially foreign source (sec. 863).

Source of transportation income

The Code provides generally that rental income from property located in the United States is U.S. source income and rental income from property located outside the United States is foreign source income (secs. 861(a)(4) and 862(a)(4)). Further, in general, income from transportation or other services rendered partly within and partly without the United States is partly U.S. source income and partly foreign source income (sec. 863(b)(1)). Treasury regulations (Treas. Reg. secs. 1.861-5, 1.862-1(a)(4), and 1.863-4) and rulings provided more detailed source rules for transportation income.

Under the regulations and rulings, the source of transportation income generally depended under prior law on whether the income was rental income (bareboat charter hire) or transportation service income (e.g., time or voyage charter hire). If the income was rental income, it was foreign source income to the extent allocable to periods when the vessel was outside the United States and its territorial waters (the three-mile limit), whether that voyage was between two U.S. ports, a U.S. port and a U.S. possession port, or a U.S. port and a foreign port (Rev. Rul. 75-483, 1975-2 C.B. 286). If the income was a payment for transportation services between two U.S. ports, a U.S. port and a U.S. possession port, or a U.S.. port and a foreign port, the income was allocated between U.S. and foreign sources by comparing costs incurred within the United States' territorial limits and costs incurred outside the United States' territorial limits (IRS Private Letter Ruling 8229005, March 30, 1982).

Whether income attributable to transportation of cargo between two U.S. ports (or between a U.S. port and either a U.S. possession port or a foreign port) was rental income or services income, the income was mostly foreign source income provided the route of transport lay primarily beyond the three-mile limit. Thus, for example, persons who transport crude oil from Alaska to West Coast points or, by way of the Panamanian pipeline, to East Coast points, may have treated income earned from such transportation as deriving from foreign sources to the extent allocable to periods when the transporting vessel was outside the U.S. territorial limit.

Reasons for Change

The purpose of the foreign tax credit is to mitigate double taxation. Treating transportation income attributable to transportation beginning and ending in the United States as foreign source income increases the foreign tax credit limitation of the carrier and affiliates by income that does not have a nexus with any foreign country. (Conversely, treating losses from this kind of transportation income as foreign source losses reduces the taxpayers' foreign tax credit limitation despite the absence of a nexus with a foreign country.) If the carrier or its affiliates have excess foreign tax credits as a result of unrelated foreign operations, an increase in the foreign tax credit limitation effectively enables the carrier to use the excess credits to offset all or part of any U.S. tax that should be imposed on the transportation income. The result is an inflating of the limitation by a shifting of what are economically U.S. earnings to foreign sources. (Conversely, taxpayers with shipping losses may have suffered an undue detriment under prior law.)

Moreover, foreign persons who earn income from transportation that begins and ends in the United States (such as foreign lessors of containers that travel between Alaska and the West Coast) should generally be fully subject to U.S. tax on such income.

Consistent with this policy, Congress decided that all transportation income attributable to transportation which begins and ends in the United States should be U.S. source income. Congress determined further that transportation income attributable to transportation which begins in the United States and ends in a U.S. possession (or vice-versa), because of its substantial nexus with the United States, generally should be 50-percent U.S. source income and 50-percent foreign source income. Under the prior law sourcing rules, carriers operating between points in the United States (or between points in the United States and points in U.S. possessions) could obtain predominantly foreign sourcing for transportation income earned from these routes by routing their vessels or aircraft outside the three-mile limit. Such transactions rarely had any connection with any country other than the United States.

In addition, to the extent that prior law allowed overstatement of the foreign tax credit limitation, it helped taxpayers with excess foreign tax credits, but not those without excess credits. This result provided a competitive disadvantage for taxpayers without excess foreign tax credits. Congress did not think this disadvantage appropriate.

Explanation of Provision

Under the Act, all transportation income attributable to transportation which begins and ends in the United States is treated as U.S. source income. Transportation income attributable to transportation which begins in the United States and ends in a U.S. possession (or which begins in a U.S. possession and ends in the United States) generally is treated as 50-percent U.S. source income and 50-percent foreign source income.

The Act contains an exception for certain transportation income from United States-U.S. possession (and U.S. possession-United States) routes. The Act treats such transportation income (or loss) earned from the leasing of aircraft eligible for the investment tax credit to U.S. persons (other than members of the same controlled group of corporations) who are regularly-scheduled air carriers as wholly U.S. source income (or loss). Typically, in their early years, such leases generate taxable losses rather than income and, thus, allocation of the loss to foreign sources would reduce the lessor's foreign tax credit limitation.

Transportation income or loss from transportation between U.S. possessions or within a possession is not subject to the provision for U.S. tax purposes and, thus, is not treated as 50-percent U.S. source income or loss (or as wholly U.S. source income or loss) by operation of the new rules. The possessions that use "mirror" Codes will treat transportation income from transportation between possessions or within a possession under rules analogous to the rules that the United States uses. Thus, transportation income from transportation wholly within one of these possessions will be subject to full local tax. Similarly, transportation income attributable to transportation that begins in the United States and ends in Guam, for example, will in effect be split between the United States and Guam for tax purposes. Each will have the primary right to tax half of the income.

The provision applies to both U.S. and foreign persons. For purposes of the provision, transportation income is defined as any income derived from or in connection with the use, or hiring or leasing for use, of a vessel or aircraft or the performance of services directly related to the use of such vessel or aircraft. Thus, the new source rules apply to transportation income attributable to both rentals and the provision of transportation services. Also, the new source rules apply both to companies earning transportation income and their employees, so that they apply, for example, to the income of personnel on ships. Transportation income includes income from transporting persons as well as income from shipping. The term "vessel or aircraft" includes any container used in connection with a vessel or aircraft.

Transportation of oil from U.S. points to other U.S. points, either directly or by way of a Panamanian pipeline, is transportation "which begins and ends in the United States" and thus, transportation income from such transportation is U.S. source income. The provision does not apply, however, to income for services performed in a foreign country that have an indirect connection with transportation beginning and ending in the United States. For example, income from the operation of a Panamanian pipeline will not be treated as U.S. source income under the new rules. Income from the operation of foreign storage facilities used to store cargo transported between U.S. points will not be subject to the new rules. Income from non-transportation services, such as refueling, performed outside the United States in connection with a trip beginning and ending in the United States also will not be treated as U.S. source income under the provision.

Set forth below are some rules and examples indicating whether transportation in certain circumstances will be considered to "begin and end in the United States" for purposes of the provision. These rules and examples apply analogously in determining whether transportation "begins in the United States and ends in a U.S. possession" (or vice-versa).

Generally, transportation of cargo will not be considered to "begin and end in the United States" (and thus, the provision will not cause income from such transportation to be U.S. source income) when, en route to a delivery point elsewhere in the United

States, a stop at a U.S. intermediate point is made for refueling, maintenance, loading or unloading of other cargo, or other business reasons, if the transporting vessel or aircraft took on the cargo in a foreign country. Similarly, transportation of cargo will not be considered to begin and end in the United States when it involves transportation from one U.S. point to another intermediate U.S. point where refueling, maintenance, etc., takes place before ultimate delivery of the cargo to a point in foreign country. Repackaging, recontainerization, or any other activity involving the unloading of the cargo at the U.S. intermediate point will not change these results under the provision provided the cargo is transported to its ultimate destination on the same aircraft or vessel that carried it to the intermediate U.S. point. If the cargo is transported to its ultimate destination on another aircraft or vessel, its transportation between the U.S. points will be considered to begin and end in the United States, unless two conditions are met. The conditions are that the same taxpayer transport the cargo on both legs of the trip and that the cargo not pass through U.S. customs at the intermediate U.S. point.

Transportation of persons will not be considered to "begin and end in the United States" when, en route to a destination elsewhere in the United States, a stop at a U.S. intermediate point is made for refueling, maintenance, or other business reasons, if the persons begin the trip in a foreign country and do not change aircraft or vessels at the U.S. intermediate point. Similarly, transportation of persons will not be considered to begin and end in the United States when it involves transportation from one U.S. point to an intermediate U.S. point like that just noted en route to the persons' destination in a foreign country provided, again, the persons do not change aircraft or vessels at the U.S. intermediate point.

Round-trip travel from the United States to a foreign country by persons is not transportation which begins and ends in the United States under the provision and, thus, the provision will not cause carrier transportation income attributable to such round-trip transportation to be U.S. source income. Round-trip travel by a cruise ship, originating in the United States and calling only on foreign ports is not transportation which begins and ends in the United States for purposes of the provision. Transportation income attributable to round-trip travel by persons from the United States to a U.S. possession (or vice-versa) is 50-percent rather than 100-percent U.S. source income under the provision.

Effective Date

The provision applies to transportation beginning after the date of enactment (July 18, 1984) in taxable years ending after that date.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $5 million in 1984, $13 million in 1985, $17 million in 1986, $18 million in 1987, $19 million in 1988, and $20 million in 1989.

5. Foreign Investment Companies (secs. 125 and 134 of the Act and secs. 535 and 1246 of the Code)[10]

Prior Law

U.S. taxation of foreign persons

Although U.S. corporations are subject to current U.S. taxation on worldwide income, foreign corporations are generally subject to U.S. taxation on only their U.S. source income and income from a U.S. business. Foreign corporations are generally exempt from U.S. taxation on foreign source income. A special rule applies, however, to income from the sale of commodities and futures contracts. Foreign corporations are taxable on their gains from the sale of commodities and futures contracts only when those sales are effectively connected with a trade or business in the United States. In general, by avoiding contacts with the United States, a company purchasing and selling commodities and futures contracts on U.S. markets may be able to avoid conducting a business in the United States and thus avoid direct U.S. tax (sec. 864(b)(2)(B)). In that event, gains from sales of commodities and futures contracts are exempt even though they have a U.S. source.

Dividends from one foreign corporation to another foreign corporation are taxable only if 50 percent or more of the paying foreign corporation's income from the last three years is U.S. business income, in which case the dividends are U.S. source income (in the same proportion as the gross income is U.S. business income) (sec. 861(a)(2)(B)).

Taxation of U.S. shareholders of foreign corporations

The United States generally imposes tax on the U.S. shareholder of a foreign corporation only when that shareholder receives the foreign corporation's earnings in the form of a dividend. That is, the U.S. shareholder of a foreign corporation generally may defer tax on that income until receipt of dividends.

The Subpart F provisions of the Code provide an exception to this general rule of deferral. Under these provisions, income from certain "tax haven" type activities conducted by corporations controlled by U.S. shareholders is currently taxed to them before they actually receive the income in the form of a dividend. For this purpose, tax haven activities generally include gains from trading in futures contracts in commodities. However, the Subpart F rules apply only if more than fifty percent of the voting power in the for-

[10] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, secs. 139 and 140; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1713-1719; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, secs. 127 and 130; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 409-415; and H. Rep. No. 98-861 (June 23, 1984), pp. 935-936 and 961 (Conference Report).

eign corporation is owned by U.S. persons who own (directly or indirectly) at least ten percent interests in the corporation. (Even if ownership is so concentrated that the Subpart F rules apply, the rules apply only to those U.S. persons who are considered to own ten percent or more of the voting power in the foreign corporation.)

Two other, similar sets of rules, the personal holding company rules and the foreign personal holding company rules, could also subject foreign corporations or their U.S. shareholders to current taxation on passive investment income or futures trading income, but these rules apply only if five or fewer individuals own (directly or indirectly) more than fifty percent in value of the stock of a foreign corporation. In general, only one of these three sets of rules will apply to tax that income.

The accumulated earnings tax

The accumulated earnings tax is aimed at corporations accumulating income for the purpose of avoiding tax at the shareholder level. The accumulated earnings tax (which reaches a maximum rate of 38.5%) generally applies to a U.S. or foreign corporation formed or availed of for the purpose of avoiding the U.S. income tax on shareholders by accumulating earnings at the corporate level rather than distributing earnings.

Under Treasury Regulations, the tax did not apply to foreign source income (Treas. Reg. sec. 1.532-1(c)). Under prior law, it may have been unclear whether a foreign parent corporation and a foreign subsidiary corporation (earning U.S. source income) from which the foreign parent received dividends were subject to this tax, however. If the subsidiary distributed all its U.S. source earnings as dividends to its parent, those dividends were generally deductible from accumulated earnings. Therefore, there may have been no accumulated earnings at the level of the subsidiary to which the accumulated earnings tax could apply. The parent corporation may have been able to avoid the accumulated earnings tax on the theory that all of its income was foreign source income (such as dividends from its subsidiary) not effectively connected with a U.S. trade or business.

The Internal Revenue Service may have argued in such a case that imposition of an accumulated earnings tax on the earnings of either foreign corporation was appropriate. First, the statute and the Regulations allow imposition of the accumulated earnings tax if the avoidance of tax at the shareholder level is accomplished through the use of a chain of corporations. (See Treas. reg. sec. 1.532-1(a)(2).) Second, the Code gives the Secretary authority to disregard certain tax benefits associated with a corporation if the corporation was acquired for the principal purpose of evading or avoiding Federal income tax (sec. 269).

Shareholder level tax on disposition of the investment

Code rules attempt to prevent U.S. taxpayers from repatriating foreign earnings at the lower capital gains rates after deferring tax on those earnings. Gains of a U.S. person who was a ten-percent shareholder (during a five-year period) in a controlled foreign corporation on the disposition of that corporation's stock are subject to ordinary income (dividend) treatment rather than capital gains treatment to the extent of that person's share of the post-1962 earnings and profits of the controlled foreign corporation (sec. 1248). Wide dispersal of a foreign corporation's stock ownership can avoid controlled corporation status.

Another provision, the foreign investment company provision (sec. 1246), generally applied to any foreign corporation that was either (1) registered under the Investment Company Act of 1940 or (2) engaged primarily in the business of investing or trading in securities (as generally defined in that Act) when more than 50 percent of the corporation's stock (by value or by voting power) was held (directly or indirectly) by U.S. persons. When a U.S. person disposes of stock in a foreign investment company, that person is subject to ordinary income treatment to the extent of his share of the foreign investment company's earnings and profits. A foreign corporation that did not register under the Investment Company Act avoided the first of these criteria. In addition, certain case law held that commodities did not constitute securities for purposes of that Act, so that a company that was engaged primarily in the business of investing or trading in commodities may have avoided the second criterion.

Marking-to-market of futures trading income

The Economic Recovery Tax Act of 1981 (P.L. 97-34) adopted a mark-to-market rule for the taxation of certain commodity futures contracts (Code sec. 1256(a)). Thus, each such regulated futures contract held by a taxpayer is treated as if it were sold or otherwise liquidated for fair market value on the last business day of the year. A maximum rate of 32 percent applies to this income. U.S. taxpayers investing through a pass-through entity (such as a limited partnership) organized in the United States in such futures contracts would be subject to this mark-to-market rule.

Foreign corporations not engaged in U.S. trade or business are not subject to the mark-to-market rule.

Reasons for Change

Background

A mutual fund may have, using some of the rules described above, attempted to defer U.S. tax and to convert trading income (ordinarily taxed as 60 percent long-term gain and 40 percent short-term gain) to 100 percent long-term capital gain through the use of two foreign corporations, one of which ("the Parent") owned all the shares of the other ("the Subsidiary"). The fund would establish and operate these foreign corporations in tax haven jurisdictions, which impose no tax on their operations.

U.S. taxation of foreign persons

The Parent may have traded in non-U.S. commodity markets (and avoided having any U.S. source income), while the Subsidiary may have traded in U.S. commodity markets (and earned all the U.S. source income that either corporation earned). In general, by carefully structuring its activities, the Subsidiary may have been able to avoid having a business in the United States and thus may have avoided U.S. tax on gains from commodity trading activities (sec. 864(b)(2)(B)).

The Parent may have been able to avoid U.S. tax if it was a foreign corporation with no U.S. source income. Its income would have consisted mainly of (1) dividends from the Subsidiary, which should not have been U.S. source, and (2) gains from trading on non-U.S. commodities markets, which result in foreign source income.

Taxation of U.S. shareholders of foreign corporations

The fund may have planned to avoid U.S. shareholder level tax on the earnings of the Parent and the Subsidiary by having the Parent distribute no dividends. Shareholders would have had to dispose of their shares to receive any income.

To decontrol these corporations for purposes of anti-tax avoidance rules including the controlled foreign corporation rules, the Parent would have restricted transfers of its shares, and it would have attempted to spread ownership of its shares by U.S. persons among many such persons.

Accumulated earnings tax

The fund may have planned its operations so as to try to avoid the accumulated earnings tax. It may have tried to benefit from the general rule that the tax did not apply to foreign source income. This was one of the primary reasons to set up two foreign corporations (the Parent and the Subsidiary) rather than one. The parties involved would have argued that the Subsidiary was not be subject to the tax because it would have distributed all its U.S. source earnings as dividends to the Parent. The fund would have argued that there were no accumulated earnings at the level of the Subsidiary to which the accumulated earning tax could apply. The fund sought to avoid the accumulated earning tax at the level of the Parent by having all the Parent's income be foreign source income.

The validity of these positions under prior law, however, was unclear, and the Internal Revenue Service may have argued that imposition of an accumulated earnings tax on the earnings of the Parent or the Subsidiary was appropriate.

To avoid potential challenges to its position on the accumulated earnings tax, the fund may have alleged that its corporate structure had no tax avoidance purpose. The issue would have been one of intent.

Shareholder level tax on disposition of the investment

Under this plan, the shareholder realized income from the investment by disposing of the interest in the offshore corporation rather than by being paid the earnings. A major element in this plan was to permit U.S. investors in the fund to realize capital rather than ordinary gain from their investment when they sold. Such treatment would have circumvented the Code's rules that attempt to prevent U.S. taxpayers from repatriating foreign earnings at the lower long-term capital gains rates after deferring tax on those earnings. The fund would have planned to avoid this rule by causing such wide dispersal of the Parent's stock ownership as to avoid controlled foreign corporation status.

The fund would have planned to avoid the foreign investment company provision (sec. 1246) by failing to register the Parent or the Subsidiary under the Investment Company Act and by relying on case law that held that commodities did not constitute securities for purposes of that Act.

Marking-to-market of futures trading income

U.S. investors could have avoided the mark-to-market rule by interposing corporations between themselves and the investments. A similar result could have been achieved though the use of a domestic corporation at the investor's level, but the corporation would be subject to the mark-to-market rules.

Congressional concerns

Congress was concerned that the abusive use of tax havens by U.S. persons through transactions like those described above poses a significant threat to the U.S. tax base. While Congress recognized legitimate uses of tax haven entities, it also recognized that any use of tax haven entities must be carefully scrutinized. Particularly troublesome are those cases in which U.S. taxpayers seek to use a foreign entity, which is not much more than a conduit, to shield U.S. income from U.S. tax.

Such a situation came to the attention of Congress with the result that Congress reviewed certain anti-abuse provisions of the Code and found uncertainties that needed to be clarified. In particular, Congress believed that for purposes of insuring that investment income of a U.S.-controlled foreign investment company not be converted to capital gain, no distinction should be made between security transactions and other investment transactions. Accordingly, Congress expanded the scope of the foreign investment company rules.

Also, Congress believed it inappropriate to defer U.S. tax on the U.S. earnings of a foreign company, or to permit mere receipt of U.S.-source income by a foreign corporation and its payment to another foreign corporation controlled by U.S. persons to change the source of that income. Accordingly, Congress amended the accumulated earnings tax rules to insure U.S. tax in such cases.

Congress believed that the tax haven plans described above may not have yielded the results that taxpayers sought under prior law. Nonetheless, Congress believed that legislation was appropriate to clarify the law in this area.

In addition, Congress amended the foreign investment company rules to reach foreign corporations that are 50-percent U.S.-owned as well as foreign corporations that are more than 50-percent U.S.-owned. In this context, Congress believed that when U.S. ownership of a foreign investment company in terms of either voting power or value is sufficiently high, it is proper to impose appropriate U.S. tax rules. Congress believed that taxpayers might be able to abuse either a voting power standard alone or a value standard alone.

Explanation of Provisions

a. Definition of foreign investment company (sec. 1246 of the Code)

The Act expands the definition of "foreign investment company" (sec. 1246), for purposes of determining when gain on the sale of shares of stock is ordinary rather than capital. A foreign investment company includes any foreign corporation that is engaged (or holds itself out as being engaged) primarily in the business of investing, reinvesting, or trading in securities, commodities, or any interest (including a futures or forward contract or option) in commodities or securities, at a time when 50 percent 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 U.S. persons. For this purpose, "securities" are defined in section 2(a)(36) of the Investment Company Act of 1940, as amended. If that definition in the Investment Company Act is amended in the future, then the definition for Internal Revenue Code purposes will also change. A primary effect of this provision is to bring commodity trading companies within the definition of foreign investment company. The Act generally does not affect the treatment of foreign corporations registered under the 1940 Act.

Effective date.—The provision applies generally to sales and exchanges (and distributions) on or after September 29, 1983. In the case of shares held on September 29, 1983, and held continuously thereafter by one taxpayer until sale, exchange, or distribution, however, the bill applies to sales and exchanges (and distributions) made after July 18, 1985 (the date that is one year after the date of enactment).

b. Extension of accumulated earnings tax to U.S.-owned foreign corporations (sec. 535 of the Code)

The Act makes it clear that U.S. persons cannot use two or more tiers of foreign corporations to avoid the accumulated earnings tax on certain U.S. earnings. For purposes of the accumulated earnings tax rules (secs. 531-537), if more than 10 percent of the earnings and profits of any foreign corporation for any taxable year are derived from sources within the United States or are effectively connected with the conduct of a trade or business within the United States, then any distribution received (directly or indirectly) by a United States-owned foreign corporation out of those earnings and profits will be treated as derived by the receiving corporation from sources within the United States. That is, the earnings retain their U.S. source or U.S. connection in the hands of the receiving (upper-tier) corporation, so that they are subject to the accumulated earnings tax. A similar rule applies to interest paid by a foreign corporation. If the paying corporation meets the 10-percent earnings and and profits threshold, all interest it pays to a U.S.-owned foreign corporation is U.S. source income for the purpose of the accumulated earnings tax.

Congress intended that the accumulated earnings tax apply in appropriate cases to U.S. source income in the hands of a United States-owned foreign corporation whether or not those earnings are effectively connected with the conduct of a U.S. trade or business, and whether or not those earnings in the hands of the United States-owned foreign corporation are attributable to earnings that are effectively connected with the conduct of a U.S. trade or business.

The Act defines the term "United States-owned foreign corporation" by cross-reference to mean any foreign corporation if 50 percent 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 U.S. persons. This provision applies to closely held and publicly held foreign corporations alike.

Effective date.—This provision applies to distributions received by a United States-owned foreign corporation on or after May 23, 1983. In the case of a foreign corporation that was a United States-owned foreign corporation on May 23, 1983, however, the provision will first apply in the first taxable year of the foreign corporation that begins after December 31, 1984.

Effective Date

The effective dates for these provisions are included above in the "Explanation of Provisions."

Revenue Effect

These provisions are estimated to increase budget receipts by less than $10 million annually.

6. Extension of Moratorium on Application of Research and Experimental Expense Allocation Regulation (sec. 126 of the Act)[11]

Prior Law

Foreign tax credit and source rules

All income has either a U.S. source or a foreign source. The foreign tax credit can offset tax on foreign-source taxable income, but not U.S.-source taxable income. (This is known as the foreign tax credit limitation.) A shift in the source of income from foreign to U.S. may increase U.S. tax by reducing the amount of foreign tax that a taxpayer may credit.

In determining foreign-source taxable income for purposes of computing the foreign tax credit limitation, and for other tax purposes, Code sections 861-863 require taxpayers to allocate or apportion expenses between foreign-source income and U.S.-source income. A shift in the allocation of expenses from foreign- to U.S.-source gross income increases foreign-source taxable income. This increase may reduce U.S. tax by increasing the amount of foreign tax that a taxpayer may credit.

Research and experimental expense allocation regulation

Treasury regulation sec. 1.861-8 (published in 1977) sets forth detailed rules for allocating and apportioning several categories of expenses, including deductible research and experimental expenditures ("research expenses"). The regulation provides that research expenses are ordinarily considered definitely related to all gross income reasonably connected with one or more of 32 product categories based on two-digit classifications of the Standard Industrial Classification ("SIC") system. Research expenses are not traced solely to the income generated by the particular product which benefited from the research activity. Instead these expenses are associated with all the income within the SIC product group in which the product is classified.

Research expenses identified with an SIC product group are generally apportioned to foreign-source income based on the ratio of total foreign-source sales receipts (or, at the taxpayer's option and subject to certain conditions, total foreign-source gross income) within the SIC product group to the taxpayer's total worldwide sales receipts (or gross income) within the SIC product group. However, research expenses incurred to meet legal requirements imposed with respect to improvement or marketing of specific prod-

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[11] For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 873; S. Prt. No. 98-169, Vol. I (April 2, 1984), pp. 882-85; and H. Rep. No. 98-861 (June 23, 1984), pp. 1262-63 (Conference Report).

ucts or processes are allocable entirely to one geographic source if the research and development cannot reasonably be expected to generate income (beyond de minimis amounts) outside that geographic source. In addition, the regulation provides that 30 percent of research expense is apportioned to the geographic source where over half of the taxpayer's research and development is performed. A taxpayer can choose to apportion to this geographic source greater than 30 percent of research expense if he establishes that a higher percentage is warranted because the research and development is reasonably expected to have a very limited or long-delayed application outside that geographic source. Treas. Reg. sec. 1.861-8 generally requires a smaller allocation of research expense to foreign-source income than a predecessor regulation proposed in 1973 would have required.[12]

Temporary moratorium and Treasury study

The Economic Recovery Tax Act of 1981 (ERTA) provided that, for a taxpayer's first two taxable years beginning after the date of its enactment (August 13, 1981), all research and experimental expenditures (within the meaning of Code sec. 174) which were paid or incurred in those taxable years, for research activities conducted in the United States, were to be allocated or apportioned to sources within the United States (sec. 223 of ERTA). The two-year moratorium on the application of the research and experimental expense allocation rules of Treas. Reg. sec. 1.861-8 did not apply to taxable years following the taxpayer's second taxable year commencing after August 13, 1981.

One reason Congress cited for enacting the two-year moratorium was that some foreign countries do not allow deductions under their tax laws for expenses of research activities conducted in the United States. Taxpayers argued that this disallowance resulted in unduly high foreign taxes and that, absent changes in the foreign tax credit limitation, U.S. taxpayers would lose foreign tax credits. Because those taxpayers could take their deductions for foreign tax purposes if the research occurred in the foreign country, taxpayers argued that there was a tax incentive to shift their research expenditures to those foreign markets in countries whose laws allow tax deductions only for research expenditures incurred locally.

Accordingly, Congress concluded that the Treasury Department should study the impact of the allocation of research expenses under Treas. Reg. sec. 1.861-8 on U.S.-based research activities and on the availability of the foreign tax credit. While that study was being conducted by the Treasury and considered by Congress, Congress concluded that expenses should be charged to the cost of generating U.S.-source income, whether or not such research was a direct or indirect cost of producing foreign-source income.

In June 1983 the Secretary of the Treasury submitted its report on the mandated study to the Senate Committee on Finance and the House Committee on Ways and Means.[13] In summary, the Treasury report concluded that:

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[12] See 38 Fed. Reg. 15,840 (1973).

[13] See Department of the Treasury, The Impact of the Section 861-8 Regulation on U.S. Research and Development (June 1983).

(1) Had Treas. Reg. sec. 1.861-8 fully been in effect in 1982, the $37 billion in privately financed domestic research and development spending in 1982 would have been reduced by approximately $40-$260 million. Most of the reduction would have represented a net reduction in overall research and development undertaken by U.S. corporations and their foreign affiliates, rather than a transfer of research and development abroad.

(2) The moratorium reduced U.S. tax liabilities. If the research and development rules of Treas. Reg. sec. 1.861-8 had been in effect in 1982, U.S. tax liabilities of U.S. firms would have been $100 million to $240 million higher.

(3) The moratorium reduced the tax liabilities only of firms with excess foreign tax credits. Whether or not a firm had excess foreign tax credits did not seem to be closely related to the level of its research and development efforts.

(4) The moratorium had its most significant effect on large, mature multinationals as opposed to small, relatively young high-technology companies. Of the $100 million to $240 million estimated increase in U.S. tax liabilities for calendar 1982 that would have occurred had Treas. Reg. sec. 1.861-8 been fully in effect, about 85 percent was estimated to be accounted for by 24 U.S. firms on the list of the 100 largest U.S. industrial corporations compiled by Fortune Magazine.

(5) An allocation of research and development expense to foreign income could increase a taxpayer's worldwide tax liability if the foreign government did not allow the apportioned expense as a deduction. Some allocation to foreign income, however, was appropriate on tax policy grounds when domestic research and development was exploited in a foreign market and generated foreign income. If an allocation were not made, foreign-source taxable income would be too high and the higher limitation could allow the credit for foreign tax to reduce U.S. tax on domestic-source income.

(6) The research and development rules of Treas. Reg. sec. 1.861-8 reflected significant modifications of the 1973 proposed version of the regulation in response to taxpayer comments. Compared to the 1973 version of the regulations, these modifications allowed less research and development expense to be allocated to foreign income and recognized that research and development conducted in the United States might be most valuable in the domestic market.

On the ground that a reduction in research and development might adversely affect the competitive position of the United States, the Treasury report recommended a two-year extension of the moratorium to provide Congress with an opportunity to consider the report's findings while it worked with the Administration to develop a coherent national program of research and development incentives.

Reasons for Change

Congress believed that it was appropriate to require the allocation of deductible expenses between U.S. and foreign-source income. At the same time, Congress believed that the Federal tax laws should generally encourage U.S.-based research activity. Congress was concerned that the research and experimental expense allocation rules of Treas. Reg. sec. 1.861-8 might result in reduced domestic research and experimental expenditures and might cause the performance of some research overseas that would otherwise be performed in the United States.

Congress also recognized that tax incentives for research frequently increased Federal budget deficits and that some tax incentives for research could be more equitable or efficient than others. In light of fiscal restraints, Congress considered it important that the relative equity and efficiency of the moratorium on the application of the Treas. Reg. sec. 1.861-8 research expense rules, compared to alternative tax incentives, be fully analyzed before any particular tax incentive was permanently adopted.

Congress, therefore, decided that a two-year extension of the present temporary moratorium was warranted. The extension was intended to allow Congress to consider further the results of the Treasury study on the Treasury research expense allocation rules. The extension should give Congress and the Treasury an opportunity to assess more fully the impact of Treas. Reg. sec. 1.861-8 on U.S.-based research activity and to determine finally whether the allocation of all U.S.-based research expenditures to U.S. sources is an effective research incentive compared to other possible research incentives.

Explanation of Provision

The Act effectively extends for two years the moratorium on the application of the research and experimental expense allocation rules of Treas. Reg. sec. 1.861-8. Under the Act, for taxable years beginning generally after August 13, 1983 and before August 1, 1985, all of a taxpayer's research and experimental expenditures (within the meaning of Code sec. 174) attributable to research activities conducted in the United States are to be allocated to sources within the United States for purposes of computing taxable income from U.S. sources and from sources partly within and partly without the United States.

This special allocation rule applies only to the allocation of research and experimental expenditures for the purposes of geographic sourcing of income. It does not apply for other purposes, such as the computation of combined taxable income of a DISC (or FSC) and its related supplier.

The extension of the moratorium does 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.

Effective Date

The extension of the moratorium on the application of the Treasury's research and experimental expense allocation regulation generally applies to a taxpayer's taxable years beginning after August 13, 1983 and on or before August 1, 1985 only. However, in the event the taxpayer's third taxable year commencing after August 13, 1981 does not begin during this period, the extension of the moratorium applies to that taxable year also.

Revenue Effect

This provision is estimated to reduce fiscal year budget receipts by $61 million in 1984, $127 million in 1985, and $66 million in 1986.

7. Repeal of 30-Percent Withholding Tax on Portfolio Interest Paid to Foreign Persons (sec. 127 of the Act and secs. 163, 864, 871, 881, 1441, 1442, and 2105 of the Code)[14]

Prior Law and Background

In general

The United States taxes the worldwide income of U.S. citizens, residents, and corporations (in the case of foreign source income, a dollar-for-dollar credit is allowed for any foreign income tax paid, subject to certain limitations). Nonresident aliens and foreign corporations, however, are generally taxed on only their income which is from U.S. sources or which is effectively connected with a business conducted by them in the United States.

Withholding tax on foreign persons

Where the U.S. source income received by a nonresident alien or foreign corporation is interest, dividends, or other similar types of investment income, the United States imposes a flat 30-percent tax on the gross amount paid (subject to reduction in rate or exemption by U.S. tax treaties, as described below) if such income or gain is not effectively connected with the conduct of a trade or business by the taxpayer within the United States (Code secs. 871(a) and 881). This tax is generally collected by means of withholding by the person making the payment to the foreign recipient of the income (secs. 1441 and 1442) and, accordingly, the tax is generally referred to as a withholding tax. In most instances, the amount withheld by the U.S. payor is the final tax liability of the foreign recipient and thus the foreign recipient files no U.S. tax return with respect to this income.

If the interest, dividend, or other similar income is effectively connected with a U.S. trade or business of the foreign investor, the income is not subject to the flat 30-percent withholding tax, but instead is included in the U.S. income tax return which must be filed for the business and is taxed at the ordinary graduated rates.

Exemptions from the withholding tax

The law provided some exemptions from the 30-percent tax on gross income, both directly and by the treatment of certain income as foreign source income rather than U.S. source income. Interest from deposits with persons carrying on the banking business and similar institutions is foreign source income and is therefore exempt (secs. 861(a)(1)(A) and 861(c)). Original issue discount on ob-

[14] For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 142; S. Prt. No. 98-169, Vol. I (April 2, 1984), pp. 416-24; H. Rep. No. 98-861 (June 23, 1984), pp. 936-38 (Conference Report); and H. Con. Res. 328, 130 Cong. Rec. S8944-45 (June 29, 1984), H7526 (June 29, 1984).

ligations maturing in six months or less is exempt (secs. 871(a)(1)(A) and (C) and 881(a) (1) and (3)). Any interest and dividends paid by a domestic corporation which earns less than 20 percent of its gross income from sources within the United States (an "80/20 company") is also exempt from the 30-percent tax (secs. 861(a)(1)(B) and 861(a)(2)(A)). Also, interest on certain debt obligations which were part of a debt issue with respect to which an election had been made for purposes of the expired Interest Equalization Tax is exempt (secs. 861(a)(1)(G) and 4912(c)).

The income of foreign governments from investments in the United States in bonds, stocks and other securities, or from interest on bank deposits, is generally exempt from U.S. tax (sec. 892). Treasury regulations deny this exemption for income which the foreign government receives from commercial activities in the United States or income which inures to the benefit of any private person.

Individuals who are neither citizens nor domiciliaries of the United States are not subject to estate tax liability with respect to stock or debt obligations of a foreign corporation or debt obligations or bank deposits yielding interest that would not be subject to the 30-percent withholding tax if the decedent received it at the time of his death (secs. 2104 and 2105). There is no estate tax liability in the case of an obligation of a U.S. corporation's foreign finance subsidiary, or in the case of a foreign corporation established to hold U.S. assets.

Tax treaty exemptions

In addition to the statutory exemptions listed above, various income tax treaties of the United States provide either for an exemption or a reduced rate of tax for U.S. source interest paid to foreign persons covered by these treaties. The exemption or reduced rate applies only if the income is not attributable to a trade or business conducted in the United States through a permanent establishment or fixed base located in the United States. The U.S income tax treaty with the Netherlands (as extended to the Netherlands Antilles) generally exempts U.S. source interest paid to Netherlands Antilles persons from withholding tax.

Background—Eurobond market and international finance subsidiaries

A major capital market outside the United States is the Eurobond market. It is not an organized exchange, but rather a network of underwriters and financial institutions that market bonds issued by private corporations (including but not limited to finance subsidiaries of U.S. companies), foreign governments and government agencies, and other borrowers.

In addition to individuals, purchasers of the bonds include institutions such as banks (frequently purchasing on behalf of investors with custodial accounts managed by the banks), investment companies, insurance companies, and pension funds. There is a liquid and well-capitalized secondary market for the bonds with rules of fair practice enforced by the Association of International Bond Dealers. Although a majority of the bond issues in the Eurobond market are denominated in dollars (whether or not the issuer is a U.S. corporation), bonds issued in the Eurobond market are also frequently denominated in other currencies (even at times when issued by U.S. multinationals).

In general, debt securities in the Eurobond market are free of taxes withheld at source, and the issuer is generally required to pay interest, premiums, and principal net of any tax which might be withheld at source (although the issuer often has the right to call the obligations in the event that a withholding tax is imposed as a result of a change in law or interpretation occurring after the obligations are issued). Thus, an issuer's borrowing cost is higher to the extent that payments must be grossed up to cover withholding tax. U.S. corporations issue bonds in the Eurobond market free of U.S. withholding tax through the use of international finance subsidiaries, almost all of which are incorporated in the Netherlands Antilles.

Finance subsidiaries of U.S. corporations are usually paper corporations, often without employees or fixed assets, which are organized to make one or more offerings in the Eurobond market, with the proceeds to be relent to the U.S. parent or to domestic or foreign affiliates. The finance subsidiary's indebtedness to the foreign bondholders is guaranteed by the U.S. parent (or other affiliates). Alternatively, the subsidiary's indebtedness is secured by notes of the U.S. parent (or other affiliates) issued to the Antilles subsidiary in exchange for the loan proceeds of the bond issue. Under this arrangement, the U.S. parent (or other U.S. affiliate) receives the cash proceeds of the bond issue but pays the interest to the Antilles finance subsidiary rather than directly to the foreign bondholders.

Some have argued that the U.S. withholding tax was avoided by claiming the benefits of the tax treaty between the United States and the Netherlands, as extended to the Netherlands Antilles.[15] Pursuant to Article VIII of the treaty, an exemption was claimed from the U.S. withholding tax on the interest payments by the U.S. parent and affiliates to the Antilles finance subsidiary. The interest payments which the Antilles subsidiary in turn pays to the foreign bondholders are not subject to tax by the Antilles. Although most or all of the income of the Antilles finance subsidiary consists of interest payments from its U.S. parent and affiliates, that interest income would not ordinarily be treated as effectively connected with a U.S. trade or business of the Antilles subsidiary.

Since less than 50 percent of the gross income of the Antilles finance subsidiary is effectively connected with a U.S. trade or business, no part of the interest paid by the Antilles finance subsidiary to the foreign bondholders would be considered to be from U.S. sources and no U.S. second-tier withholding tax would be imposed (sec. 861(a)(1)(C)).[16] Thus, no withholding tax is paid on the interest

[15] Except as noted below, Congress did not intend to create any inference regarding the operation of the relevant treaty and Code provisions in this situation.

[16] Even if the income of the finance subsidiary (the interest it receives from its U.S. parent and affiliates) were treated as effectively connected with a U.S. trade or business, the interest paid by the Antilles finance subsidiary would nevertheless be exempt from U.S. tax under Article XII of the treaty. This situation may be advantageous when the taxpayer is in an excess foreign tax credit position because, while subject to U.S. tax on its net income (the spread between the interest it receives and the amounts it pays to the foreign bondholders), the finance subsidiary is not required to make an election to be subject to higher Netherlands Antilles tax rates in order to be free of the U.S. withholding tax.

paid by the U.S. company to its Antilles finance subsidiary, or on the interest paid by the Antilles finance subsidiary to the foreign bondholders, either to the United States or to the Netherlands Antilles.

Because of a finance subsidiary's limited activities, the lack of any significant earning power other than in connection with the parent guarantee and the notes of the parent and other affiliates, and the absence of any substantial business purpose other than the avoidance of U.S. withholding tax, offerings by finance subsidiaries involved difficult U.S. tax issues in the absence of favorable IRS rulings. Since the marketing of a bond offering is based upon the reputation and earning power of the parent, and since the foreign investor is ultimately looking to the U.S. parent for payment of principal and interest, there was a risk that the bonds might have been treated as, in substance, debt of the parent, rather than the subsidiary, and thus withholding could have been required.[17]

Alternatively, the creation of the finance subsidiary might be viewed as having as its principal purpose the avoidance of the withholding tax, which becomes an obligation of the U.S. parent by virtue of its status as a withholding agent (sec. 1461), with the result that the exemption might not apply (sec. 269). Nevertheless, these finance subsidiary arrangements do satisfy in form the requirements for an exemption from the withholding tax, and a number of legal arguments would support the taxation of these arrangements in accordance with their form. Notwithstanding the refusal of the IRS since 1974 to issue rulings with respect to Antilles finance subsidiaries, many bonds have been issued since 1974 (with the number of issues increasing in recent years) on the basis of opinions of counsel.

In recent years, however, field agents of the IRS have challenged certain arrangements involving Antilles finance subsidiaries on audit.[18] The outcome to these challenges was not clear as this legislation proceeded through Congress. In addition, the United States and the Netherlands Antilles are in the process of renegotiating the existing treaty.

Typically, the U.S. parent and the finance subsidiary agree to indemnify the foreign bondholder against all U.S. withholding taxes (including interest and penalties) should the IRS successfully attack the claimed exemption from U.S. withholding tax or should U.S. tax law or the tax treaty with the Netherlands Antilles be changed to eliminate the basis for the claimed exemption. Also, the bonds typically provide that if U.S. withholding tax is imposed, the bonds are immediately callable.

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[17] Compare, e.g., Aiken Industries, Inc., 56 T.C. 925 (1971), and Plantation Patterns, Inc. v. Commissioner, 462 F.2d 712 (5th Cir. 1972), 72-2 U.S.T.C. Paragraph 9494, cert. denied, 406 U.S. 1076, with Moline Properties, 319 U.S. 436 (1943), 43-1 U.S.T.C. Paragraph 9464 and Perry R. Bass, 50 T.C. 595 (1968).

[18] According to one source, there had been challenges to at least 25 of these arrangements. See 46 Taxes International 13 (August 1983). At least one company, Texas International Airlines, disclosed such an audit in a proxy statement. Fialka, "Closing a Loophole," Wall Street Journal, Oct. 11, 1982, at 17, col. 2.

TEFRA compliance rules

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) restricts the issuance of long-term bearer obligations by imposing a direct prohibition on the issuance of these obligations by the United States and its agencies or instrumentalities and by denying certain tax benefits to issuers and holders of other bearer obligations. In addition, TEFRA imposes an excise tax on issuers of bearer obligations that are registration-required obligations but not issued in registered form (other than obligations required to be registered under Code sec. 103(j)).

No sanction is imposed, however, on the issuance in bearer form of (1) obligations of a natural person, (2) obligations with a maturity at issue of not more than one year, and (3) obligations of a type not offered to the public. In addition, an exemption from the registration requirements is provided for certain obligations designed for issuance to foreign persons. Specifically, an obligation is not required to be issued in registered form if it is sold under procedures reasonably designed to prevent sale or resale to U.S. persons, it bears interest payable outside the United States only, and it indicates on its face that U.S. holders are subject to penalties. However, TEFRA gave the Secretary of the Treasury authority to require registration of these obligations designed for foreign markets (and short-term and non-public obligations) if, with respect to specific types of obligations, he determined that such obligations were used frequently to avoid Federal taxes.

Congress enacted the TEFRA registration requirements because it believed that a fair and efficient system of information reporting and withholding could not be achieved with respect to interest-bearing obligations as long as a significant volume of unregistered long-term instruments were being issued. Further, Congress decided that a system of registration would reduce the ability of non-complying taxpayers to conceal income and property from the reach of the income, estate, and gift taxes. Finally, Congress decided that a registration requirement could reduce the volume of readily negotiable substitutes for cash available to persons engaged in illegal activities.

Reasons for Change

Congress believed it important that U.S. businesses have access to the Eurobond market as a source of capital. Congress believed that the imposition of a withholding tax on portfolio interest paid on debt obligations issued by U.S. persons might impair the ability of U.S. corporations to raise capital in the Eurobond market. International bond issues are often exempt from withholding taxes and estate taxes imposed by foreign governments. By contrast, under prior law, U.S. bond issues generally were not exempt from the U.S. withholding tax although, as indicated above, a patchwork of statutory exceptions to the withholding tax existed, and the tax was frequently reduced or eliminated by treaty.

As explained above, to avoid the withholding tax, U.S. corporations seeking access to the Eurobond market generally established international finance subsidiaries to issue Eurobonds, almost all of which were incorporated in the Netherlands Antilles. Exemption from withholding tax was claimed under the U.S. income tax treaty with the Netherlands, as extended to the Netherland Antilles.

Congress believed that if tax-free access to the Eurobond market is important, such access should be direct. In Congress' view, the practice by U.S. corporations of issuing Eurobonds through finance subsidiaries located in the Netherlands Antilles, rather than directly from the United States, was neither economical nor indicative of sound tax policy. Congress was informed that the practice imposed additional costs on the issuing corporations and, in many cases, provided incomplete access to the Eurobond market. The cost of Eurobond borrowing to U.S. corporations, it was thought, would probably be lower were Eurobonds issued directly from the United States, utilizing existing U.S. office resources and personnel.

At the same time, Congress was informed that the risk that U.S. withholding tax could be imposed on interest paid on Eurobonds issued by U.S. corporations sometimes made it difficult to trade U.S. obligations in international bond markets, since holders of international obligations desire assurance that there will be no withholding tax on any interest income which they may derive. To satisfy this desire of foreign lenders, U.S. corporate borrowers, as explained above, typically indemnified the foreign bondholders against all U.S. withholding tax in the event the IRS successfully attacked the claimed exemption or the Netherlands Antilles tax treaty was changed to eliminate the basis for the claimed exemption. This also raised the cost which a U.S. borrower had to incur when it went into foreign markets to raise capital.

For these reasons, Congress believed that the 30-percent withholding tax on interest paid to foreign corporations and nonresident alien individuals by a U.S. borrower on portfolio debt investments generally should be repealed. Repeal should allow U.S. corporations (and the U.S. Treasury) direct access to the Eurobond market.

Congress was concerned, however, that repeal of the 30-percent tax on pre-existing obligations issued directly by U.S. persons and held by foreign persons would have provided those foreign persons with a windfall tax reduction: the price of, and rate of return on, such obligations were set assuming that a withholding tax would apply. In addition, Congress was concerned that repeal of the withholding tax could have a substantial negative impact on the economy of the Netherland Antilles. Because repeal of the 30-percent tax makes it unnecessary for U.S. corporations to route future borrowings through the Antilles, the use of the Antilles as a financial center is likely to be substantially reduced. Repeal of the 30-percent tax with respect to pre-existing obligations could have prompted U.S. corporations that had previously issued obligations through Antilles finance subsidiaries in an effort to avoid the tax to assume those pre-existing obligations directly and, thus, discontinue finance operations in the Antilles well before the obligations mature. Congress was informed that offshore financing activities generate a large portion of the Antilles budget. Congress believed that, while offshore financings generally should be scrutinized closely by the IRS and tax treaties should not be used as a basis for establishing conduits whose existence results in a transfer of revenues from the

U.S. Treasury, the Antilles should have some time to adjust to tax law changes that affect its economy.

For these reasons, Congress decided to repeal the 30-percent tax on interest paid on portfolio debt investments issued after the date of enactment only. Thus, foreign persons holding pre-existing obligations will not receive an unwarranted tax reduction. Furthermore, U.S. parent corporations may not avoid U.S. tax on pre-existing obligations issued by Antilles finance subsidiaries by assuming the obligations and paying interest on them from the United States; Congress believed that a repeal of the 30-percent tax with prospective effect only would result in a gradual and orderly reduction of international financing activity in the Netherlands Antilles and thus mitigate any economic hardship that the withholding tax repeal might indirectly impose on that country.

Congress was aware that the provisions of the Act that maintain the source of U.S. source income and the character of interest income (secs. 121 and 122 of the Act) might also indirectly affect the Antilles economy. Congress believed, however, that any such effect was likely to be less pronounced than that of withholding tax repeal; also, part of the purpose of the provisions in question is to address tax abuses while the repeal of the 30-percent tax is intended to rationalize and clarify the tax rules affecting overseas borrowing by U.S. businesses.

In repealing the 30-percent tax on portfolio interest, Congress was also concerned about potential compliance problems in connection with obligations issued in bearer form. As a result of compliance problems associated with bearer obligations, TEFRA imposes substantial restrictions on the issuance of bearer obligations. However, TEFRA generally permits the issuance of bearer obligations that satisfy requirements designed to insure that the obligations will be issued to and held by foreign persons only. Repeal of the 30-percent tax on portfolio interest paid on bearer obligations could lead to an increase in the volume of U.S. bearer obligations in existence worldwide, thus exacerbating existing compliance difficulties associated with bearer obligations. Repeal might also provide some U.S. persons with a new avenue of tax evasion: To evade tax on interest income, U.S. persons might attempt to buy U.S. bearer obligations overseas, claiming to be foreign persons, notwithstanding the TEFRA restrictions on foreign-targeted bearer obligations. These persons might then claim the new statutory exemption from withholding tax for the interest paid on the obligations and fail to declare the interest income on their U.S. tax returns, without concern (since the obligations are in bearer rather than registered form) that their ownership of the obligations will come to the attention of the IRS.

Because of these concerns, Congress decided to expand the Treasury's authority to require registration of obligations designed to be sold to foreign persons. Accordingly, the Act grants the Secretary full discretion to exclude obligations from the TEFRA registration exemption for foreign-targeted issues without the necessity of any finding of frequent tax avoidance usage.

Congress did not believe it appropriate to repeal the 30-percent tax for interest paid to related foreign parties, because the combination of U.S. deduction and non-inclusion would create an incentive for interest payments that Congress did not intend. Moreover, Congress did not believe it appropriate to allow foreign corporations controlled by U.S. taxpayers to enjoy both (1) exemption from U.S. withholding tax and (2) deferral of taxation on passive interest income (at the U.S. shareholder level). In addition, the Act's rules maintaining the source of U.S. source income and the character of interest income that flows through a foreign corporation frequently do not operate unless a foreign corporation's U.S. source income or interest income exceeds certain threshold amounts. Congress believed that controlled foreign corporations should benefit from the repeal of the withholding tax only to the extent that their income that benefits from repeal is currently taxed to their U.S. owners and retains its source and character in the hands of those U.S. owners.

Explanation of Provision

Repeal of 30-percent tax

The Act generally repeals the 30-percent withholding tax on interest paid by a U.S. borrower on certain portfolio debt investments where the interest is received by a nonresident alien individual or a foreign corporation. The new exemption applies only to interest paid on portfolio obligations issued after the date of enactment. Thus, the 30-percent tax continues to apply to pre-existing obligations subject to the tax.

Specifically, the 30-percent tax is repealed for interest paid on two categories of portfolio debt investments. First, interest paid on certain obligations not in registered form, i.e., payable to the person who has physical possession of the paper debt instrument, is eligible for the exemption. For the interest to be exempt, the underlying bearer obligation must be exempt from the TEFRA registration requirements on the basis that it is sold under procedures reasonably designed to prevent sale or resale to U.S. persons, bear interest payable outside the United States and its possessions only, and indicate that U.S. holders are subject to tax penalties. Obligations of the United States and its agencies are among those that may fall in this category. Since enactment, however, temporary Treasury regulations and announcements have indicated that debt of the United States and of U.S. agencies will not be issued in bearer form, and that certain debt of private issuers that is backed by U.S. or U.S. agency debt will not qualify for exemption from the 30-percent tax if issued in bearer form.

Because of compliance problems associated with bearer debt, the Act authorizes the Secretary to exclude any future obligation from the exemption from the TEFRA registration requirements for foreign-targeted issues without regard to whether the obligation is determined to be used frequently in avoiding Federal taxes. Thus, the Act grants the Secretary full discretion to require registration of foreign-targeted issues.

The 30-percent tax also is repealed for interest paid on certain obligations issued in registered form, provided the U.S. payor (or U.S. person whose duty it would otherwise be to withhold tax) has received a statement that the beneficial owner of the obligation is not a U.S. person. The statement must be made by either the beneficial owner of the obligation or a securities clearing organization, a bank, or other financial institution that holds customers' securities in the ordinary course of its business. The Secretary has authority to publish a determination to the effect that statements from a securities clearing organization, bank, or other financial institution, or any class of such persons, are not adequate to qualify an obligation for this second category of obligations within the scope of the repeal. Interest paid one month or more after publication of a notice of inadequacy will be subject to the 30-percent tax, and the agent paying interest in such a case will have a duty to deduct and withhold U.S. tax at the 30-percent rate.

Not all interest on instruments in the above two categories is eligible for the exemption from tax. Interest is not eligible for the exemption if it is effectively connected with the conduct by the foreign recipient of a trade or business within the United States and is, therefore, taxable at the regular graduated rates.

Interest is also not eligible for the exemption if it is paid to a foreign person having a direct ownership interest in the U.S. payor. In the case of payments from domestic corporations, direct ownership exists if the recipient of the interest owns, or is considered as owning or constructively owning, 10 percent or more of the total combined voting power of all classes of stock entitled to vote of that corporation. In the case of interest paid by a domestic partnership, direct ownership exists if the recipient of the interest owns or is considered as owning or constructively owning 10 percent or more of the capital or profits interest in the partnership. In addition, foreign banks are generally not eligible for the exemption with respect to interest they receive on debt on an extension of credit pursuant to a loan agreement entered into in the ordinary course of their banking business. Whether a foreign bank will be considered to have extended credit pursuant to a loan agreement entered into in the ordinary course of its banking business will be determined, with respect to a particular obligation, under regulations prescribed by the Secretary. Interest on any obligation that performs the function of a loan entered into in the ordinary course of banking business will be ineligible for the exemption. Interest on an obligation that does not perform that function—for example, a Eurobond held by a foreign bank as an investment asset—may be eligible for the exemption. Foreign banks also may obtain the exemption with respect to otherwise eligible interest paid on obligations of the United States. In addition to addressing a Federal Reserve concern regarding reserve requirements, the foreign bank exception was intended to prevent U.S. banks, which are subject to U.S. tax on interest income, from suffering a competitive disadvantage vis a vis foreign banks that make loans to U.S. persons.

Congress was concerned that taxpayers might attempt to circumvent the 10-percent shareholder and foreign bank exclusions by entering into "back to back" loans, wherein a foreign affiliate of a U.S. taxpayer or a foreign bank lends money to an unrelated foreign party that relends that money at discount to the U.S. taxpayer. Congress intended that the IRS, when appropriate, use means at its disposal to determine whether back to back loans exist.

Interest paid to a controlled foreign corporation by a related person (within the meaning of new Code sec. 864(d)(4), added by the

Act) is not eligible for the exemption from withholding tax. Interest paid to a controlled foreign corporation by a person other than a related person may be eligible for the exemption, however. To prevent U.S. persons from indirectly taking advantage of the repeal of withholding tax, the Act provides that interest eligible for the repeal under the Act that is paid to a controlled foreign corporation is includible in the gross income of the controlled foreign corporation's U.S. shareholders under subpart F (Code sec. 951) without regard to the 10-percent exception or any of the other exceptions otherwise provided under the subpart F rules. Such interest in the hands of a controlled foreign corporation retains its U.S. source and its character as interest (under Code sec. 904, as amended by the Act) upon subpart F or other income inclusion, without regard to any exception from the Code section 904 rules available for other income.

Treasury regulations issued since enactment restrict the exemption from the 30-percent tax to portfolio interest on obligations that are registration-required (or would be registration-required but for the foreign issue exception (section 163(f)(2)(B))) under the TEFRA compliance rules restricting the issuance of long-term bearer obligations. Thus, under the regulations, the exemption does not apply if the issuer of the obligation is a natural person, if the maturity of the obligation at issuance is less than a year, or if the obligation is not of a type offered to the public (T.D. 7967, Q&A-1, Q&A-8 (August 17, 1984)). Congress intended that interest (and original issue discount) on publicly traded mortgage pass-through securities be eligible for the exemption from the 30-percent tax. Congress considers these securities to be registration-required under the TEFRA compliance rules.[19]

Estate tax

The Act eliminates any potential U.S. estate tax liability of nonresident alien individuals dying after the date of enactment in the case of obligations the income of which, if received by the decedent at the time of his death, would be exempt from the 30-percent tax under this provision. Only obligations issued after the date of enactment are eligible for the estate tax exclusion.

Other rules

If the Secretary determines that the United States is not receiving adequate information from a foreign country to prevent evasion of U.S. income tax by U.S. persons, the Secretary may provide in

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[19] For most Code purposes, income received from an entity taxable as a trust (such as a mortgage pass-through trust) is characterized by reference to the underlying obligation held by the entity, on which the income was originally earned, rather than by reference to the interest in the investing entity held by the investor. However, in determining whether an interest in certain intermediate investing entities, such as mortgage pass-through trusts, is registration-required under TEFRA, it is the nature of the interest itself that is relevant; if the interest is liquid and actively traded, it would pose compliance problems were it not registration-required. Mortgage pass-through securities are liquid and actively traded. As they are readily negotiable substitutes for cash, Congress considers them to be subject to the TEFRA registration requirements. The determination of the applicability of the registration requirements with reference to these securities rather than with reference to the underlying mortgages does not imply, for example, that interest income passed through an intermediate mortgage-investing entity to holders of such securities will be eligible for the exemption from the 30-percent tax where the interest income derives from underlying mortgages originated before the date of enactment.

writing (and publish a statement) that the repeal of withholding tax will not apply to payments of interest addressed to or for the account of persons within that country for issuances of debt obligations after the date of publication of the Secretary's determination. The termination will continue until the Secretary determines that the exchange of information between the United States and that country is adequate to prevent the evasion of U.S. income tax by U.S. persons. Any termination for interest will also automatically terminate the exemption from the estate tax on debt obligations.

Under the Act, an explicit duty to deduct and withhold tax at the 30-percent rate arises only if the person otherwise subject to the duty knows, or has reason to know, that the interest is subject to tax at the 30-percent rate because the recipient is a controlled foreign corporation related to the payor, has a direct ownership interest in the U.S. payor, or (except in the case of interest paid on an obligation of the United States) is a bank and the interest is received on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of the bank's business.

The Act provides that, if the requirements set forth below are met, interest paid to an "applicable CFC" (within the meaning of Code sec. 904(g), as amended by the Act but with a requirement that the CFC be an applicable CFC on the date of the interest payment rather than on March 31, 1984) on a U.S. affiliate obligation will be treated for all Code purposes as paid to a resident of the country in which the applicable CFC is incorporated. If the requirements set forth below are met, Congress intended, in addition, that the applicable CFC receiving the interest be recognized as a separate corporation and, as a result, the CFC obligation(s) corresponding to the U.S. affiliate obligation be recognized as obligation(s) of the applicable CFC.[20]

The requirements are that the payee was an applicable CFC on or before June 22, 1984, the U.S. affiliate obligation on which the interest is paid was issued before June 22, 1984, and that on the date the interest is paid, the payee satisfies requirements based upon the principles set forth in four revenue rulings issued in connection with the Interest Equalization Tax (Rev. Rul. 69-377, 69-2 C.B. 231; Rev. Rul. 69-501, 69-2 C.B. 233; Rev. Rul. 70-645, 70-2 C.B. 273; and Rev. Rul. 73-110, 73-1 C.B. 454). These principles include, among other things, the maintenance of a specified debt-equity ratio. U.S. affiliate obligations issued before June 22, 1984 (the date of conference action) include rollovers—with or without a change in interest—of pre-June 22, 1984 affiliate obligations and new affiliate obligations which are substituted for the pre-June 22, 1984 U.S. affiliate obligations, as long as the total amount of U.S. affiliate obligations is not increased by the foregoing and so long as the applicable CFC does not acquire new funds after June 22, 1984.[21] For instance, the applicable CFC cannot avail itself of this rollover provision if it issues new debt to raise new capital after June 22, 1984. Congress did not intend, however, for example, that an applicable CFC lose the benefit of this treatment on account of a contribution to capital made to increase the applicable CFC's debt-equity ratio

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[20] *See* 130 Cong. Rec. S8417 (June 27, 1984) (statement of Sen. Wallop).
[21] *Id.*

that is necessary because of the accrual of original issue discount after June 22, 1984, on an obligation outstanding on June 22, 1984.

No inference is to be drawn from this special relief provision for applicable CFCs regarding the proper resolution of other tax issues. Congress did not intend this relief provision to serve as precedent for the U.S. tax treatment of other transactions involving tax treaties or domestic tax law. The relief provision does not exempt any applicable CFC from the Act rules that maintain the source of U.S. source income and the character of interest income (Act secs. 121 and 122; Code secs. 904(g) and 904(d)(3).[22]

Effective Date

The repeal of the 30-percent tax on portfolio interest applies to portfolio interest received after the date of enactment (July 18, 1984) with respect to obligations issued after that date. The estate tax exclusion for debt obligations applies to obligations issued after the date of enactment with respect to estates of decedents dying after that date.

Revenue Effect

This provision is estimated to reduce fiscal year budget receipts by $2 million in 1984, $33 million in 1985, $65 million in 1986, $62 million in 1987, $40 million in 1988, and $10 million in 1989.

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[22] *See* 130 Cong. Rec. S8417 (June 27, 1984) (statement of Sen. Dole).

8. Original Issue Discount and Coupon Stripping—Foreign Investors (sec. 128 of the Act and secs. 163, 871, and 881 of the Code)[23]

Prior Law

Background—foreign investors generally

In general, foreign corporations and nonresident aliens are subject to a flat 30-percent U.S. tax on certain U.S. source income not effectively connected with the conduct of a U.S. trade or business. Effectively connected income is taxed at the rates that apply to U.S. persons. In general, foreign investors are subject to the flat 30-percent tax on U.S. ordinary income, while their U.S. source capital gains (other than real estate gains) are not taxable. Under prior law, amounts subject to the 30-percent tax in the hands of foreign investors included amounts received as dividends, rents, salaries, "interest (other than original issue discount as defined in section 1232(b)). . . and other fixed or determinable annual or periodical gains, profits, and income" (secs. 871(a)(1)(A), 881(a)(1)).

Original issue discount

Corporate and government obligations

Under prior law, foreign investors may have been able to defer tax on certain original issue discount (OID) on obligations of corporations and governments until disposition of the debt instrument. To the extent that deferral of tax was not available, however, these foreign investors may have been subject to the accelerated recognition rules that caused front-end loading of OID income of U.S. persons prior to the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).

Although interest on which foreign investors are taxable did not include "original issue discount as defined in section 1232(b)," this exclusion of OID from interest did not exclude all OID from tax. The tax rules governing OID distinguished between pre-April 1, 1972, issues and post-March 31, 1972, issues (secs. 871(a)(1)(C) and 881(a)(3), before amendment by the Act). (Some distinctions continue under the Act.)

Deferral on pre-April 1, 1972, issues

Foreign investors generally defer the 30-percent tax on OID on debt issued before April 1, 1972, until disposition (sec. 871(a)(1)(C)(i), before amendment by the Act). This result occurs because these

[23] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 134; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1329-1333; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 124; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 374-378; and H. Rep. No. 98-861 (June 23, 1984), pp. 938-940 (Conference Report).

foreign investors are generally in the same position as U.S. persons holding pre-May 27, 1969, debt (sec. 1232(a)(2)(B), before amendment by the Act). That is, this OID is not subject to the 30-percent tax until sale, exchange, or surrender at maturity. There is no current taxation on ratable amounts of this OID (see S. Rpt. 92-437, 92d Cong., 1st Sess., 1972-1 C.B. 559, 601).

Post-March 31, 1972 issues

Foreign investors who acquired debt issued after March 31, 1972, and payable more than 6 months[24] from the date of issue were subject to tax on such debt in three ways.

First, they were and are subject to tax on the actual interest they receive (on the coupons they clip) (see sec. 871(a)(1)(A)).

Second, when they received a periodic interest payment, they were subject to tax on the OID "accrued" between the immediately preceding interest payment and the date of the interest payment in question, but "the total amount withheld is not to exceed the amount of interest paid" (S. Rep. No. 92-437, above) (see sec. 871(a)(1)(C)(iii), before amendment by the Act).

Third, on sale or surrender, the foreign investor was and is subject to tax on the OID not previously taxed (secs. 871(a)(1)(C)(ii), 1232(a)(2)(B); S. Rpt. 92-437, above). Therefore, if the foreign investor buys a zero coupon bond and keeps it until maturity, he was not and is not liable for any U.S. tax until that time. Low-coupon discount bonds yielded (and continue to yield) partial tax deferral.

Obligations of partnerships, etc.

OID on noncorporate debt was taxable no later than the time of disposition. The Internal Revenue Service proposed in 1976 to treat OID on "obligations not issued by a corporation or by a government or political subdivision thereof" like OID on post-March 31, 1972, corporate debt. Proposed Reg. sec. 1.871-7(c)(4)(i). That is, according to the proposed regulation, foreign investors were subject to tax on OID on debt issued by partnerships, individuals and other entities that were not corporations or governments ("noncorporate" issuers) upon receipt of coupon interest to the extent of net after-30-percent-tax interest. Any excess tax was due at the time of disposition.

Coupon stripping

Coupons.—Receipt of an interest payment upon surrender of a stripped coupon was taxable at the 30-percent rate. If the foreign investor could establish basis for the surrendered coupon by showing that he or she had purchased it, he or she should have, under normal concepts, reduced the taxable income. The treatment of a sale of a stripped coupon before maturity was unclear. Foreign investors were not taxed on OID "as defined in section 1232(b)" (section 871(a)(1)(A), before amendment by the Act). They were taxed on "interest," however (and are taxed on interest other than "portfolio interest" after enactment of the Act). The increased value of stripped bonds and stripped coupons may not have been "OID as

[24] These persons pay no tax on OID on debt payable 6 months or less from the issue date. This result was deliberate. S. Rpt. 92-437, above.

defined in section 1232(b)". This additional value may have been an "amount received . . . as . . . interest (other than original issue discount as defined in section 1232(b)" on which such investors were subject to tax.[25]

If sale of a stripped coupon resulted in capital gain for U.S. persons,[26] however, a similar sale by a foreign investor may not have been taxable under the general rule that foreign investors pay no tax on capital gains.

Bonds.—Surrender of a stripped bond at maturity or sale of such a bond may have generated an "amount received . . . as . . . interest (other than original issue discount as defined in section 1232(b)" or "other fixed or determinable annual or periodical income," either of which would have been subject to the U.S. 30-percent withholding tax. This treatment would have paralleled the treatment of stripped coupons, discussed above. Surrender of a stripped bond at maturity or sale of such a bond was free of tax to the extent that the gain was capital.

Interest deduction of issuer of OID debt

Under prior law, a U.S. person who issued debt at original issue discount to a foreign person could accrue interest deductions on account of the debt during the term of the debt, even though (if the income was not effectively connected with a U.S. trade or business) the foreign person was not liable for tax on the accruing OID until receipt of some coupon interest or the sale or exchange of the debt instrument.

Reasons for Change

Although Congress repealed the U.S. tax on certain interest paid to foreign investors, some interest paid to foreign investors does not qualify for that repeal, and Congress sought to rationalize the rules governing interest paid or accrued to foreigners that remains taxable. Congress intended generally to make the rules governing income from original issue discount debt and income from stripped bonds and coupons consistent for U.S. persons and taxable foreign investors. To this end, Congress made technical corrections to rules enacted in the Revenue Act of 1971. In addition, Congress sought to fulfill the original intent of TEFRA that the TEFRA modifications of the coupon-stripping rules and the OID rules that applied to U.S. persons also apply to taxable foreign investors. Congress also intended to coordinate the changes to the OID rules that the Act made with respect to U.S. investors so that those changes generally apply to taxable foreign investors as well.

Congress also considered the problem of mismatching of (1) an accrual basis U.S. OID debt issuer's tax deductions and (2) a foreign investor's income inclusion. Congress addressed part of this problem by delaying the interest deduction for interest accrued, but not

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[25] Arguably, this additional value was instead "other fixed or determinable annual or periodical income" subject to tax. Cf. Subcommittee on OID of the N.Y. State Bar, "Taxation and Withholding for OID Realized by Nonresident, Aliens and Foreign Corporations," 25 Tax Lawyer 201, 213 (1972), arguing, prior to the 1972 statutory changes, that much OID was such income.

[26] Certain sales of stripped coupons before maturity arguably yielded capital gains treatment (see Rev. Rul. 54-251, 1954-2 C.B. 172). Such sales could have yielded interest income, however.

paid, to related foreign parties with respect to an original issue discount obligation until actual payment. Congress saw no justification for mismatching in the case of related party OID debt when such mismatching allows an economic entity that consists of more than one legal entity to contract with itself at the expense of the U.S. Government.

In addition, Congress was concerned that the interplay of the timing rules and U.S. income tax treaties could give an undue advantage to related parties who lend and borrow by using OID debt rather than debt paying stated interest. The United States has, in a series of income tax treaties, waived the right to tax certain U.S. source income in favor of the country of residence of the person earning the income. If the United States allowed its taxpayers to deduct accruing OID on debt they issue to related foreigners who (1) pay no or a reduced U.S. tax because of an income tax treaty and (2) delay inclusion under the laws of their home country (the treaty partner of the United States) until receipt of interest, then these parties would have an advantage in using OID debt rather than debt paying stated interest. Congress saw no reason to allow this artificial tax advantage for any related-party transactions.

Congress understood that the anti-abuse measure in the Act does not end the abuse of mismatching. For the time being, however, Congress limited the deferral of deductions to the case of interest accrued to related parties. Congress believed that further examination of the deductibility of OID accrued to foreign parties is appropriate. In addition, Congress understood that taxpayers might attempt to circumvent the Act's related party rule by entering into "back to back" loans, wherein a foreign affiliate of a U.S. taxpayer lends money to an unrelated foreign party that relends that money at discount to the U.S. taxpayer. Congress intended that the Internal Revenue Service, when appropriate, investigate the capitalization of foreign-owned U.S. corporations issuing OID debt to unrelated foreign parties to attempt to determine whether back to back loans exist and to impose the proper tax and penalties on each party to the transaction.

Explanation of Provisions

Original issue discount

When a nonresident alien individual or a foreign corporation receives an interest payment on an OID obligation that is still subject to tax, notwithstanding the repeal of the U.S. tax on portfolio interest paid to foreign investors, an amount equal to the OID accrued on the obligation since the last payment of interest thereon is generally subject to U.S. tax. A technical correction will be necessary to make any accrued but untaxed OID subject to tax, whether or not it accrued since the last interest payment. This correction will prevent undue deferral if taxpayers seek to time interest payments to defeat the purpose of the rule. However, OID is taken into account for this purpose only to the extent that the tax on the OID does not exceed the interest payment less the (30-percent or lower treaty rate) tax imposed on the interest payment. The Act thus makes it clear that the entire amount of the interest payment may be used to satisfy U.S. income tax.

On the sale, exchange, or retirement of an OID obligation, the amount of any gain not in excess of the OID accruing while the foreign investor held the obligation is subject to tax (to the extent that such discount was not theretofore taken into account upon a payment of interest). The Act indicates that the amount subject to tax cannot exceed the gain the foreign investor realizes on the sale, exchange, or retirement. Congress did not intend this gain limitation; a technical correction will be necessary to make it clear that the amount subject to tax can exceed the gain realized.

As a general rule, domestic holders of OID instruments include OID in income daily, and the inclusion increases basis (sec. 1272(a)(1), 1272(d)(2)). Congress did not intend this increase in basis to apply to untaxed foreign investors, however. The basis of the OID instrument for the purpose of computing gain does not increase during the period the foreign investor holds it unless the United States taxed the investor on the OID.

These new rules apply to OID regardless of whether the instrument is a capital asset in the hands of its holder, regardless of the period that the foreign investor holds it, and regardless of the identity of the issuer. Interest other than original issue discount (as defined in new section 1273) is taxable under the rules that previously governed interest "other than original issue discount as defined in sec. 1232(b)."

As under prior law, the Act generally defines original issue discount obligation to mean any bond or other evidence of indebtedness having original issue discount. That term does not include, however, any obligation payable 183 days or less from the date of original issue (without regard to the period held by the taxpayer) or any obligation that is tax-exempt under section 103 or under any other provision of law without regard to the identity of the holder. Generally, original issue discount means the difference between the issue price and the stated redemption price at maturity (new sec. 1273).

The Act determines the amount of the OID which accrues during any period under the new rules generally applicable to U.S. persons (new sec. 1274) or under the corresponding provisions of prior law (without regard to exemptions in any of those rules or any provisions for short-term obligations). Thus, for example, with respect to instruments issued after July 1, 1982, OID generally accrues on the basis of a constant interest rate. As for debt issued by natural persons, however, OID accrues on the basis of a constant interest rate only for post-March 1, 1984, issues. For debt issued before July 2, 1982, OID accrues on a straight-line basis.

Except to the extent provided in regulations prescribed by the Secretary, the determination of whether any amount taxable under this OID provision is from sources within the United States is to be made at the time of payment (of sale or exchange or retirement) as if the payment (or sale or exchange or retirement) involved the payment of interest. Congress provided regulatory authority because the Act's general source rule may not always produce the proper source of OID income. For instance, an obligor issues a 20-year zero-coupon bond to a foreign investor. On the same day, the U.S. obligor issues a 20-year interest-bearing bond to a second foreign investor. For 19 of the 20 years of the interest-bearing bond's term most or all of the interest that the obligor pays on the interest-bearing bond is U.S.-source interest. In the twentieth year, interest that the obligor pays on the interest-bearing bond is foreign-source interest (because, for example, the obligor is an individual who has changed his or her residence or a corporation whose income is no longer effectively connected with a U.S. trade or business). Congress anticipated that regulations could provide that the bulk of the income that arises from the OID on the zero coupon bond in this case is U.S.-source income.

Stripped instruments

The Act provides that the rules treating stripped bonds and stripped coupons purchased after July 1, 1982, as obligations with original issue discount in the hands of U.S. persons (new sec. 1286) apply to foreign investors. Thus, foreign investors generally treat stripped coupons and stripped bonds acquired after July 1, 1982, as OID instruments. This treatment generally conforms the treatment of foreign investors to that of U.S. investors, except that foreign investors are not subject to tax until actual receipt of payment.

Timing of deduction for OID accrued to related foreign lenders

The Act delays the interest deduction for interest accrued, but not paid, to related foreign lenders with respect to an original issue discount obligation until actual payment. An example illustrates the operation of this rule. The foreign parent of a U.S. corporation lends the U.S. corporation money in exchange for a noninterest bearing discount bond that the foreign parent holds until maturity. (The repeal of the 30-percent withholding tax on interest paid to certain foreign investors does not apply to interest paid to 10-percent foreign shareholders of (and certain other parties related to) a U.S. corporation.) Under the Act, the U.S. corporation cannot deduct interest on the bond until it pays the foreign parent the cash due on the obligation at maturity.

In the case of a discount obligation bearing stated interest, the obligor may deduct in a given year only the amount paid to related lender in that year. For example, the foreign parent of a U.S. corporation has lent the U.S. corporation money in exchange for an interest bearing discount bond. In a given year, the stated interest on the bond is $30, while the OID accruing on the bond is $150. The amount subject to U.S. tax in the hands of the foreign parent in that year is $100. This $100 represents the $30 of stated interest plus $70 of accrued OID. The OID amount is only $70 because OID (under the Act) is subject to U.S. tax only to the extent that the tax on the OID (without reduction on account of an income tax treaty) does not exceed the interest payment less the 30-percent withholding tax (again without reduction on account of an income tax treaty) imposed on the interest payment. The deduction of the U.S. borrower is $30, whether or not the foreign lender benefits from an income tax treaty to which the United States is a party.

Congress limited the deduction in the example above to the amount paid ($30) rather than the amount subject to tax ($100) because of a concern that treaty country resident lenders and related U.S. borrowers could otherwise defeat the purpose of the rule. For example, if the lender in this example were a resident of a country that taxed holders of OID debt only on receipt of payment, and whose tax treaty with the United States exempted the interest paid or accrued to the lender from U.S. tax, and if Congress had allowed a deduction for the $100 subject to tax, the related parties would have obtained a $100 deduction in the United States (worth perhaps $46) with no U.S. tax on any of the interest and a foreign tax on only $30. Congress did not think it appropriate to base the amount deductible in this kind of case on the amount subject to tax. Congress did not intend to leave related parties flexibility to plan around this rule.

Congress did not intend to delay deduction for OID accrued to related foreign parties that are subject to U.S. tax after the application of treaties. For instance, OID accruing to a related foreign party on which it currently pays U.S. tax as income effectively connected with the conduct of a U.S. business should be currently deductible. A technical correction will be necessary to reflect this policy.

Effective Date

The Act generally applies to payments, sales, exchanges, or retirements on or after September 16, 1984 and with respect to obligations issued after March 31, 1972. As noted above, the Act does not affect the computation of the accrual of OID of pre-July 2, 1982 debt, and it does not affect stripped instruments acquired before July 2, 1982. The rule delaying interest deductions for OID accrued but unpaid to foreign related parties applies to obligations issued after June 9, 1984.

Revenue Effect

These provisions will have a negligible effect on revenues.

9. Withholding on Dispositions by Foreigners of U.S. Real Property Interests (sec. 129 of the Act and secs. 1445 and 6039C of the Code)[27]

Prior Law

In 1980, Congress adopted the Foreign Investment in Real Property Tax Act (FIRPTA).[28] FIRPTA requires foreign persons who dispose of U.S. real property interests to pay tax on any gain realized on the disposition. The interests on whose disposition recognition occurs include real estate and shares in certain corporations owning primarily real estate. The intent of the legislation was to treat foreign investors the same as U.S. persons by removing certain preferential tax treatment previously accorded them.

FIRPTA provided for enforcement of the tax on foreign persons through a system of information reporting designed to identify foreign owners (rather than sellers) of U.S. real property interests. FIRPTA required the Secretary of the Treasury to issue regulations providing for reporting. Temporary and proposed regulations were issued (47 F.R. 41532 and 47 F.R. 41581) but the reporting requirements were subsequently postponed by the Internal Revenue Service for 1980 through 1983, pending the issuance of final regulations.

Reasons for Change

A major problem with FIRPTA under prior law was that it could often be easily evaded. Since the tax was not due until a tax return was filed after the end of the year, a foreign person could sell his or her U.S. real estate, take the proceeds out of the United States, and since he or she was beyond the jurisdiction of the United States, not pay any tax to the United States on the sale. Moreover, through nominees and foreign corporations established in tax havens, he or she could reinvest these untaxed proceeds back in the United States with impunity.

Requiring the persons with control over the amount paid to withhold tax is the method used to insure collection of tax on other payments of income to foreign persons, and is used by almost all countries.

The conference on the 1980 legislation dropped a provision that would have required withholding. The conferees were concerned about protecting withholding agents who might not know that a seller is a foreign person. The conferees agreed that it would be

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[27] For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 141; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 405-08; H. Con. Res. 328, 130 Cong. Rec. S8945 (June 29, 1984), H7526 (June 29, 1984); and H. Rep. No. 98-861 (June 23, 1984), pp. 940-49 (Conference Report).

[28] P.L. 96-499.

necessary to structure withholding provisions carefully to insure that they would not inadvertently disrupt the U.S. real estate market or expose U.S. buyers or U.S. agents of foreign sellers of U.S. real estate to liability where such liability is not appropriate. The Senate voted again in 1981 and 1982 to impose withholding on sales of U.S. real property interests by foreign investors, but in each case the conferees failed to agree to withholding.

The Service had difficulty developing final regulations with respect to the FIRPTA information reporting system; it had not yet issued them, so no information reporting was required, as of the date of enactment of the Act.

Enforcement of FIRPTA through withholding has several advantages over enforcement through information reporting. Most importantly, withholding should prove more effective than information reporting, and eliminate the problem of identifying owners of bearer shares.

The withholding provisions of the Act differ substantially from those passed by the Senate in previous years and from those included in the Senate version of the 1984 legislation. The withholding system of the Act has been designed so that complication of real estate transactions and uncertainty regarding withholding liability should be minimal. In addition, its provisions should result, in many cases, in a withholding tax liability that approximates the final tax liability of a foreign seller more closely than might have been the case under earlier withholding proposals.

The Act simplifies the administration of FIRPTA and relieves U.S. persons of significant paperwork by generally repealing the information reporting requirements; the Act authorizes the Secretary to require reporting only by foreign persons holding direct investments in U.S. real property interests.

Explanation of Provision

Duty to withhold generally

The Act generally imposes a withholding obligation when a U.S. real property interest is acquired from a foreign person. Withholding is required *unless* one of five exemptions applies. The withholding obligation is generally imposed on the transferee. In certain limited circumstances, an agent of the transferor or transferee is required to withhold. No withholding obligation is generally imposed on settlement officers. The Act provides special rules for withholding by certain corporations, partnerships, trustees, and executors, and by transferees of interests in partnerships, trusts, and estates.

Any tax imposed on a foreign investor under FIRPTA in excess of amounts withheld remains the liability of the foreign investor.

Amount withheld

The amount to be withheld on the sale by a foreign investor of a U.S. real property interest generally is 10 percent of the amount realized (gross sales price). However, the amount withheld may not exceed the transferor's maximum tax liability, as determined below. Withholding at the 10-percent rate, rather than at a higher capital gain rate, is expected to result in the collection of an amount of tax that more closely approximates (in many cases) the net tax owed by a foreign investor on his gain (after basis is deducted) on a U.S. real property disposition.

The Act does not limit a withholding agent's withholding liability to the portion of the sales proceeds within his control. Because withholding generally is at a 10-percent rate only, transferees should have sufficient sales proceeds within their control to satisfy the full withholding liability in many cases. When the initial cash consideration paid by a transferee in a real property transaction is not high enough to cover this withholding liability, the parties may request a "qualifying statement" from the Internal Revenue Service authorizing the transferee to withhold a lesser amount from the initial cash payment. A qualifying statement is to be issued in this situation if the requirements for such a statement are otherwise satisfied and no abuse is involved. (Qualifying statements are discussed in more detail below). Thus, on a real estate installment sale, for example, an amount equal to 10 percent of the total sales price (or the maximum tax liability, if less) is to be withheld at the time of the first cash payment unless a qualifying statement authorizing the transferee to withhold a lesser amount from that payment is obtained.

The transferor's "maximum tax liability" consists of two elements: first, the maximum amount that the Internal Revenue Service determines that the transferor could owe on his gain on the sale, and second, any unsatisfied prior withholding tax liabilities caused by prior foreign ownership with respect to the transferred property that, under the Act, were previously required to be withheld but were not withheld. The first element, the maximum tax that the transferor could owe on the sale, is to be calculated on a transaction-by transaction basis at the highest possible tax rate for that transaction. For example, if a nonresident alien purchased unimproved land on January 1, 1984 for $100,000, and sold the land on September 1, 1985, for $120,000, his maximum tax liability for that sale would be $4,000, i.e., 20 percent, the highest marginal tax rate for long-term capital gains of an individual, times $20,000, his net gain. Neither offsetting transactions (completed or anticipated) nor the presumed absence of other income during the taxable year enter into the calculation of the maximum tax that the transferor could owe on the sale.

The Service is to establish the transferor's maximum tax liability upon request. Such a request may be made by the transferee as well as by the transferor. However, transferees may request a maximum tax liability determination only to cure overwithholding errors. The procedure is not intended to be utilized to relieve transferees from withholding responsibility *before* a transaction occurs, except at a transferor's request. In many cases, the transferee will not know the fact that would establish that the transferor's maximum tax liability is less than the tax otherwise required to be withheld (namely, the transferor's basis in the transferred property) unless and until the transferor furnishes the information to the transferee.

Transferors may request a determination of maximum tax liability before or after a disposition. A transferor may seek and obtain an early refund of any amounts withheld in excess of the transferor's maximum tax liability (subject to such terms and conditions as the Internal Revenue Service may by regulations prescribe). This provision allows a transferor to seek a refund before the transferor might otherwise file a federal income tax return. No interest will accrue on the amount of any early refund.

The Act also authorizes the Internal Revenue Service to reduce withholding if the Service determines that such a reduction will not jeopardize the collection of the U.S. tax for which the transferor is ultimately liable. A request for reduced withholding may be made by either the transferor or the transferee.

The Act requires the Internal Revenue Service to act on a request for establishment of the transferor's maximum tax liability or for reduced withholding within 90 days after the Service receives the request. Congress was informed by the Service that requiring Service action within a shorter period would be unrealistic; in many cases, Service resources would not permit it to complete action in less than 90 days. In some cases, even 90 days may not be adequate to complete action; if so, the Service's action in response to these requests may not establish the amount of tax due.

Exemptions from withholding

Transferor furnishes non-foreign affidavit

Withholding by the transferee generally is not required if the transferor furnishes to the transferee, under penalty of perjury, an affidavit stating that the transferor is not a foreign person and stating the transferor's taxpayer identification number ("non-foreign affidavit"). The Act authorizes the Internal Revenue Service to prescribe regulations requiring the transferee to furnish a copy of the non-foreign affidavit to the Internal Revenue Service. It is anticipated that any regulations requiring filing of the non-foreign affidavit with the Internal Revenue Service will also require filing of such other information as the Secretary deems appropriate (for example, a description of the real property interest transferred and the identity and taxpayer identification number of the buyer).

The receipt of a non-foreign affidavit will not relieve the transferee of withholding responsibility if the transferee has actual knowledge that the affidavit is false or he or she receives a notice from his or her agent or an agent of the transferor that the affidavit is false. A transferor's agent or transferee's agent with actual knowledge that the affidavit is false must give the transferee notice to that effect at such time and in such manner as the Secretary shall require by regulations. In the case of a foreign corporate transferor, an agent of the transferor will be deemed to have actual knowledge that any non-foreign affidavit is false. Congress believed that any agent deriving compensation from a foreign corporate principal in a real estate transaction would know that his or her principal was in fact foreign. The chances of innocent ignorance in such a case are so remote that the Act precludes a claim of ignorance.

A transferor's agent or transferee's agent that does not give the required notice will be liable for withholding as if he or she were the transferee, up to the amount of compensation the agent receives in connection with the transaction. This liability for withholding is in addition to any penalties imposed under other provisions of the Code or other laws (both civil and criminal) in connection with the failure to give notice.

The receipt of a non-foreign affidavit also will not relieve the transferee of withholding responsibility if the Internal Revenue Service by regulations requires the transferee to furnish it with a copy of the non-foreign affidavit and the transferee fails to do so.

The Act defines the term "transferor's agent" as any person who represents the transferor in any negotiation with the transferee or any transferee's agent related to the transaction, or in settling the transaction. The Act defines the term "transferee's agent" as any person who represents the transferee in any negotiation with the transferor or any transferor's agent related to the transaction, or in settling the transaction. A settlement officer will not be treated as a transferor's agent or transferee's agent merely because he receives or disburses any portion of the consideration for the transaction or records any document in connection with the transaction.

Domestic corporation furnishes non-U.S. RPHC affidavit

Withholding is not required on the disposition of an interest (other than an interest solely as a creditor) in a domestic corporation if the corporation furnishes an affidavit to the transferee stating, under penalty of perjury, that the corporation is not and has not been a U.S. real property holding corporation ("U.S. RPHC") during the base period specified in Code section 897(c)(1)(A)(ii) (the shorter of (i) the period after FIRPTA's general effective date during which the transferor held the interest and (ii) the five-year period ending on the date of disposition of the interest) ("non-U.S. RPHC affidavit"). The Act authorizes the Internal Revenue Service to prescribe regulations requiring the transferee to furnish a copy of the non-U.S. RPHC affidavit to the Internal Revenue Service.

The receipt of a non-U.S. RPHC affidavit will not relieve the transferee of withholding responsibility if the transferee has actual knowledge that the affidavit is false or the transferee receives a notice from his or her agent or an agent of the transferor that the affidavit is false. The rules imposing a duty on agents to give notice in the case of a false affidavit, including the rule imposing withholding liability on agents when they fail to give the notice required, are the same in connection with false non-U.S. RPHC affidavits as they are in connection with false non-foreign affidavits.

The receipt of a non-U.S. RPHC affidavit also will not relieve the transferee of withholding responsibility if the Internal Revenue Service by regulations requires the transferee to furnish it with a copy of the non-U.S. RPHC affidavit and the transferee fails to do so.

This exemption is intended to apply only to dispositions of stock that is not regularly traded on an established securities market ("non-publicly traded stock"). A separate exemption, discussed below, is provided for dispositions of publicly traded stock.

Under the Act, and the provisions of FIRPTA, a purchaser of non-publicly traded stock in a domestic corporation is potentially liable for withholding unless he or she obtains either a non-U.S. RPHC affidavit from the corporation or a non-foreign affidavit from the seller. If the purchaser obtains neither, he or she is liable for withholding if the seller is in fact a foreign person, the domestic corporation was in fact a U.S. RPHC during the base period specified in Code section 897(c)(1)(A)(ii)), and the purchaser does not receive a qualifying statement.

Transferee receives qualifying statement

The Act exempts from withholding transferees who receive a qualifying statement. A qualifying statement is a statement by the Internal Revenue Service that the transferor is exempt from tax, that either the transferor or the transferee has provided adequate security for payment of the tax, or that either the transferor or the transferee has made other arrangements for the payment of the tax. The deadline for action by the Service on a request for a qualifying statement is 90 days after the Service receives the request.

Purchase price for residence below designated amount

Withholding is not required if the transferee is to use the transferred real property as his residence and the amount realized by the transferor on the disposition of the property is $300,000 or less.

Stock transferred on established securities market

No withholding is required on a disposition of shares of a class of stock that is regularly traded on an established securities market. The exemption is not limited to stock regularly traded on established *U.S.* securities markets. The disposition need not occur on an established securities market to benefit from the exception.

Partnerships, trusts, estates, and corporations

The Act provides special rules for withholding by certain partnerships, trustees, executors, and corporations and by transferees of interests in partnerships, trusts, and estates. The Act authorizes the Internal Revenue Service to prescribe regulations to carry out the purposes of these rules, including regulations providing for exceptions from the rules.

Income inclusions with respect to domestic partnerships, trusts, and estates

The Act requires withholding at the 10-percent rate by a domestic partnership, a trustee of a domestic trust, or an executor of a domestic estate with respect to amounts attributable to the disposition of a U.S. real property interest that are either includible in the distributive share of a foreign partner of the partnership, includible in the income of a foreign beneficiary of the trust or estate, or includible in the income of the grantor or other substantial owner of the trust or estate (under the grantor trust rule of the Code). Consistent with the Act's general withholding rule, it was intended that withholding liability under this rule be determined by applying the 10-percent rate to the amount realized on the disposition that is includible in the income of the partner, beneficiary, or grantor, rather than to the amount received on the disposition that is actually in the custody of the partnership, trustee, or executor and that is includible in the income of the partner, beneficiary, or grantor. A technical amendment may be necessary to clarify this point. A partnership, trustee, or executor that originally acquired the disposed-of real property interest through debt financing, subsequently mortgaged the property, or agreed to accept payment for the disposed-of property on an installment basis, and, as a result, does not have sufficient sales proceeds to satisfy its withholding liability may request a qualifying statement from the Internal Revenue Service authorizing it to withhold a lesser amount.

Separate withholding rules apply to certain distributions of U.S. real property interests by partnerships, trusts, and estates; also, the Internal Revenue Service is authorized to prescribe withholding rules for dispositions of partnership interests and beneficial interests in trusts and estates (see below). The withholding rule under discussion does not apply to those distributions and dispositions subject to these separate rules.

Distributions to foreign persons by a real estate investment trust (REIT) that are attributable to gains from the disposition of U.S. real property interests are subject to withholding under the Act.

Distributions of U.S. real property interests by foreign corporations

The Act requires withholding by a foreign corporation on a distribution by the corporation of a U.S. real property interest when gain is recognized by the corporation under FIRPTA on the distribution. For example, withholding by a foreign corporation is required when the corporation distributes a U.S. real property interest to its shareholders in a liquidating distribution. The amount of tax to be withheld is 28 percent (the maximum corporate rate on capital gains) of the foreign corporation's gain. Withholding is at the maximum corporate rate on capital gains, rather than at the lower 10-percent rate, because the entity required to withhold in this instance, the foreign corporation, is itself the taxpayer; generally, the other party involved, the person to whom payment is made, is the taxpayer in transactions in which withholding is required. Also, withholding in this instance is based on the taxpayer's gain (that is, gross proceeds realized less basis) on the U.S. real property disposition rather than on the gross proceeds realized by the taxpayer.

Shareholders receiving a distribution from a foreign corporation required to withhold under this rule are not themselves required to withhold on that distribution.

Distributions by domestic U.S. RPHCs to foreign shareholders

The Act explicitly requires withholding by a domestic corporation that is (or, at any time during the five-year or shorter base period specified in Code section 897(c)(1)(A)(ii), was) a U.S. RPHC when the corporation distributes property to a foreign shareholder in a corporate liquidation or in redemption of its stock. In general, the amount of tax to be withheld is 10 percent of the gross amount of the distribution received by the foreign shareholder. While the Act's general withholding rule also requires withholding by a domestic corporation in this case where the stock surrendered is a U.S. real property interest, Congress included this specific rule to eliminate any uncertainty on this point.

Withholding by a domestic corporation is appropriate in this case because any earlier corporate-level dispositions of U.S. real property interests by the domestic corporation may have escaped tax. Such dispositions are not taxed under FIRPTA because dispositions by a *domestic* corporation are not by a "foreign person," even if all the domestic corporation's shareholders are foreign persons.

A qualifying statement granting exemption from withholding may be requested in connection with a liquidating distribution by a domestic corporation of a non-U.S. real property interest when Code section 337 nonrecognition treatment was not elected for related corporate-level dispositions of U.S. real property interests (made during the base period specified in Code section 897(c)(1)(A)(ii)) by the domestic corporation. If the section 337 election was not made, the previous corporate-level dispositions would have been subject to tax; a foreign shareholder's interest in the liquidating corporation may not be a U.S. real property interest (under the FIRPTA rule excluding from the definition of a U.S. real property interest an interest in a corporation that is not currently holding U.S. real property interests and that was fully taxed on previous corporate-level dispositions of such interests during the base period). Thus, the foreign shareholder's surrender of his interest in the corporation may not be a taxable disposition under FIRPTA.

A qualifying statement granting exemption from withholding also may be requested in connection with a distribution by a domestic corporation of a U.S. real property interest where the Code accords the distributee foreign shareholder nonrecognition treatment on the distribution and this nonrecognition treatment is not overridden by FIRPTA.

Withholding will not be required on a distribution by a domestic corporation when the stock liquidated or redeemed in connection with the distribution qualifies for the exemption from withholding for stock transferred on an established securities market (discussed above).

Taxable distributions by partnerships, trustees, and executors to foreign persons

The Act also requires withholding by a domestic or foreign partnership, the trustee of a domestic or foreign trust, or the executor of a domestic or foreign estate when the partnership, trustee, or executor makes a distribution of a U.S. real property interest to a foreign person that is a taxable distribution under the FIRPTA provisions taxing certain partnership, trust, and estate distributions[29] notwithstanding general Code rules. In general, the amount of tax to be withheld is 10 percent of the fair market value of the distributed U.S. real property interest at the time of the distribution. While the Act's general withholding rule also requires withholding in these cases, Congress wished to make clear that withholding is required.

[29] Code secs. 897(e)(2)(B) and 897(g). As drafted, the Act refers to sec. 897(g) only. It was intended that distributions treated as taxable under sec. 897(e)(2)(B) also be subject to this withholding rule; to clarify this point, a technical correction may be necessary.

Corporations making section 897(i) election

In order to simplify the administration of the withholding system—particularly the exemption procedure for persons who furnish non-foreign affidavits—the Conference Report states that Congress intended that foreign corporations electing under Code section 897(i) to be treated as domestic corporations for purposes of FIRPTA's substantive and reporting provisions continue to be treated as foreign persons for withholding purposes. It was not Congress' intention, however, to deny domestic corporation status for withholding purposes to section 897(i)-electing corporations if the Internal Revenue Service could develop procedures offering U.S. buyers reasonable assurance that a non-foreign affidavit from a foreign corporation was valid (as a result of a valid section 897(i) election by the corporation). A technical correction may be necessary clarifying the Service's authority to develop such procedures and its authority to treat section 897(i)-electing foreign corporations that comply with procedural requirements as domestic corporations for withholding purposes. To the extent that the section 897(i) election is considered to apply for withholding purposes, the election is intended to be the exclusive remedy for any person claiming discriminatory treatment under the withholding provisions.

Information reporting requirements

The Act generally repeals the information reporting requirements of FIRPTA. However, it authorizes the Internal Revenue Service to require reporting by foreign persons holding direct investments in U.S. real property interests. For this purpose, a foreign person will be treated as holding direct investments in U.S. real property interests during any calendar year if the foreign person did not engage in a U.S. trade or business at any time during the calendar year and the fair market value of the U.S. real property interests held directly by the person at any time during the calendar year was $50,000 or more.

Except in one case, a person "directly" holds a U.S. real property interest only if his disposition of the interest would be taxable under FIRPTA. For purposes of determining whether a person's U.S. real property holdings exceed the $50,000 threshold, a person will also be considered to hold "directly" any U.S. real property interests held by a partnership of which the person is a partner, a trust or estate of which the person is a beneficiary, or the spouse or a minor child of the person. However, this attribution of ownership is intended to take place only if the person holds a U.S. real property interest directly, apart from the holdings of the partnership, trust, estate, spouse, or minor child. Thus, a person not subject to FIRPTA may not be subjected to information reporting under the Act. The Internal Revenue Service may not impose look-through or similar rules in connection with reporting, under which "deemed" or "constructive" holders of U.S. real property interests are required to report, except to the extent that those required to report would be subject to tax under FIRPTA.

Congress did not believe that requiring reporting by foreign persons holding direct U.S. real property investments would be unduly intrusive or burdensome. U.S. law presently requires foreign investors in U.S. real property to furnish their names and countries of residence, as well as certain other information, to the U.S. Government, in certain circumstances. For example, the Agricultural Foreign Investment Disclosure Act of 1978 (7 U.S.C. secs. 3501-08) generally requires foreign persons who acquire U.S. agricultural land (other than certain parcels of one acre or less which generate less than $1,000 in annual gross sales) to file detailed reports on such acquisitions with the Department of Agriculture within 90 days of the transaction. Completed reports are made available for public inspection. Pursuant to the International Investment Survey Act of 1976 (22 U.S.C. secs. 3101-08), the Department of Commerce imposes various reporting requirements on foreign investors in U.S. businesses. For example, on the acquisition by a foreign company of a 10-percent (or greater) ownership interest in a U.S. business with 200 or more acres of U.S. land or $1 million or more of either assets, gross sales, or net income, the Department generally requires that the name and country of residence of the foreign company be reported and certain information about the U.S. business be provided. Information reported pursuant to the International Investment Survey Act generally may be used for analytical or statistical purposes only.

Effective Date

The withholding rules apply to dispositions of U.S. real property interests that occur on or after January 1, 1985. The date on which a foreign transferor originally acquired a U.S. real property interest is irrelevant.

The changes in the information reporting requirements are effective retroactively to calendar year 1980.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $44 million in 1984, $40 million in 1985, $10 million in 1986, $10 million in 1987, $11 million in 1988, and $14 million in 1989.

10. Use of Territories To Avoid U.S. Tax on Foreign Investors (sec. 130 of the Act and secs. 881, 1442, and 7651 of the Code)[30]

Prior Law and Background

Prior to enactment of the Act, payments of U.S. source interest to foreign investors were generally subject to a 30-percent U.S. withholding tax. Section 127 of the Act has repealed the tax for certain payments of "portfolio interest" but not for other interest payments. Payments of dividends, royalties, and other passive income to foreign investors were and are generally subject to a 30-percent U.S. withholding tax. Under prior law, the United States did not impose withholding tax, however, on payments of passive income to corporations organized in Guam or in the Commonwealth of the Northern Mariana Islands. The United States did not tax any U.S. source income (either active or passive) of "inhabitants" of the U.S. Virgin Islands. Some taxpayers contended that passive U.S. source income could flow through Guamanian or Marianas corporations or corporate inhabitants of the Virgin Islands to foreign investors outside the possessions free of U.S. tax and free of significant tax in the possession.

These possessions generally use the Internal Revenue Code as their territorial income tax law by substituting the name of the possession for the words "United States" in the Internal Revenue Code where appropriate to give the law proper effect ("mirror Code"). The United States has an "80-20" source rule that treats interest and dividends paid by a U.S. corporation as foreign source income if less than 20 percent of the corporation's gross income for a three-year period has a U.S. source (Code sec. 861(a)(1)(B) and 861(a)(2)(A)). In these possessions, then, application of the "mirror Code" might have indicated that interest and dividends paid by a corporation organized in the possession were not possession source income if less than 20 percent of the corporation's gross income for a three-year period was from sources in the possession. A possession corporation whose sole activity was investing in or lending money to its (non-possession) U.S. affiliate (or to unrelated U.S. persons), according to some taxpayers, would have earned only non-possession source income. Therefore, taxpayers contended that payments of interest and dividends from such a possession corporation to a foreign investor were free of the 30-percent possession withholding tax.

Temporary Treasury regulations and rulings, however, provided that income derived from one of these possessions that was not sub-

[30] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 137; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1342-1344; House floor amendment, 130 Cong. Rec. H. 2738 (April 11, 1984); and H. Rep. No. 98-861 (June 23, 1984), pp. 949-951 (Conference Report).

ject to tax to the recipient in the possession was U.S. source income for purposes of the "80-20" source rule. Under the mirror Code, then, income derived from the United States (such as interest paid from a U.S. corporation to its Guamanian finance subsidiary) that was not subject to U.S. tax to the recipient (because of U.S. rules exempting such income from tax) was possession source income for purposes of applying the 80-20 source rule under the possession's mirror Code. (Temp. Reg. sec. 4a.861-1; Rev. Rul. 83-9, 1983-1 C.B. 126). Under the Treasury Department's interpretation, then, if a Guamanian or Marianas corporation received interest and dividend income from a U.S. corporation, the "80-20" rule did not apply, and the possession had to impose a 30-percent withholding tax on payments from the local corporation to the foreign investor. Treasury applied similar rules to V.I. inhabitants (Rev. Rul. 83-10, 1983-1 C.B. 127). Guam challenged this Treasury interpretation in court, however, as it applied there.

Reasons for Change

Congress was generally concerned with the proliferation of conduit entities that purport to shield foreign investors from U.S. tax. Congress particularly opposed artificial devices that purport to shield foreign investors from U.S. tax on direct investment, and that purport to shield foreign investors from U.S. tax on dividends. If successful, these devices could have allowed foreign investors who buy or invest in U.S. companies a significant tax advantage over U.S. investors. More specifically, Congress did not intend that any interplay of the tax laws of the United States and the territories allow foreign investors not resident in the territories to earn, directly or indirectly, U.S. income that escapes both U.S. and territorial tax. Congress intended to make it clear that if (for some reason) it ever decides to allow use of the territories as conduits for foreign investors, or to allow other tax avoidance at variance with tax policy that it has expressed, Congress will do so specifically, and not by indirect application of U.S. tax rules that apply automatically in the territories.

Congress believed that the relationship between the tax systems of the United States and those U.S. territories whose tax systems depend on the U.S. tax Code creates uncertainty and possible opportunities for taxpayers to take positions that, if sustained, would result in tax avoidance. Congress intended, however, that neither taxpayers nor the courts should construe its action with respect to the specific problem of territorial conduit entities (and the absence of more far-reaching action) as indicating that any other tax avoidance device that depends on the laws of the territories and their relationship to U.S. tax law as it changes (from time to time) yields the result that avoidance-seeking taxpayers seek.

Congress was also aware that some foreign investors sought to use conduit corporations organized outside their home countries, in tax treaty partner countries of the United States, to avoid U.S. tax. Congress understood that the Treasury Department has adopted a policy, to be implemented in current and future income tax treaty negotiations, that will limit treaty benefits to bona fide residents of the treaty country. Congress urged the Treasury Department to continue that policy and to insist on such a result in treaty negotiations. Since enactment of the Act, two Revenue Rulings have made it clear that the income tax treaty with the Netherlands Antilles does not prevent imposition of the United States withholding tax in certain cases when an investor from a country with which the United States had no treaty lends money to a conduit corporation in the Antilles, which relends to a U.S. corporation (Rev. Ruls. 84-152 and 84-153).

Congress believed that rules that eliminate U.S. tax on payments of passive income to corporations organized in U.S. possessions should not apply to foreign-owned corporations or to corporations that derive a large portion of their gross income from outside U.S. possessions. At the same time, Congress did not wish to alter tax incentives that the possessions extend to U.S. investors.

Explanation of Provision

The Act provides that interest, dividends, and other passive income paid from U.S. sources to a corporation organized in Guam or the U.S. Virgin Islands will not be subject to U.S. tax if the recipient corporation meets two requirements: first, that at all times during the taxable year less than 25 percent in value of the stock of the corporation be owned directly or indirectly by foreign persons and second, that at least 20 percent of its gross income be shown to the satisfaction of the Secretary to have been derived from local sources for the three-year period ending with the close of the preceding taxable year of the corporation (or for such part of the three-year period as the corporation has been in existence). The Act applies not only to Guam and to the Virgin Islands, but also to other territories whose tax rules operate by reference to U.S. law or to territorial law. Specifically, the Act also applies to Northern Mariana Island corporations, because references in the Internal Revenue Code to Guam are deemed generally also to refer to the Marianas, absent expressed intent not to have them so apply (Pub. Law 94-241, sec. 601(c)).

For the purpose of the ownership requirement, the term "foreign person" means any person other than either a U.S. person or a person who would be a U.S. person if the general Internal Revenue Code definition of the United States included references to the U.S. possessions. That is, residents of the possessions are not foreign persons for this purpose. In determining whether stock of a corporation that belongs to another corporation is owned indirectly by foreign persons, only foreign persons who own five percent or more in value of the corporate shareholder are considered as owning stock in the underlying corporation. This last rule allows territorial subsidiaries of publicly traded U.S. corporations, many of whose stockholders are nominees (but with less than 25 percent in value of their stock held by foreign persons owning 5 percent or more in value), to meet the ownership requirement for reduced withholding.

The 20-percent of gross income requirement makes it clear that a corporation formed in a possession of the United States is not eligible for reduced U.S. withholding tax on any U.S. source income if it could make payments of interest or dividends that are free of withholding tax in the possession. The purpose of this requirement is to dovetail with the Code's 80-20 source rule and to assure collection of tax on foreigners who earn income from investments in the United States. If 20 percent or more of the gross income of a corporation organized in Guam, the Marianas or the Virgin Islands during the applicable period is local source income, payments from its U.S. parent are not subject to U.S. tax, but its payments to foreign investors are subject to territorial withholding tax. On the other hand, U.S. withholding tax applies to payments to a corporation chartered in one of these possessions unless its payments of interest and dividends to foreigners are subject to territorial tax.

For example, payments of U.S. source interest and dividends to a Virgin Islands corporation that (1) is owned solely by residents of the Virgin Islands and (2) derived 90 percent of its gross income for the applicable period from the Virgin Islands are not subject to U.S. tax. By contrast, payments of U.S. source interest and dividends to a Virgin Islands corporation that (1) is owned solely by residents of the Virgin Islands and (2) derived only 10 percent of its gross income for the applicable period from the Virgin Islands are subject to U.S. tax.

The Act makes it clear that this rule is not "mirrored". That is, this provision of the Act does not affect the tax imposed by Guam, the Marianas, or the Virgin Islands (under the "mirror Code") on payments of interest, dividends, and certain other income from possessions sources to U.S. corporations. Such payments from sources in Guam and the Marianas will remain free of tax in those possessions, regardless of the U.S. corporation's owners or the source of its other income (new Code sec. 881(b)(2)). Such payments from sources in the Virgin Islands remain subject to a V.I. tax of up to 10 percent (Code sec. 934A).

The Act also makes it clear that the Revised Organic Act of the Virgin Islands does not prevent the application of its rules. To that end, the Act specifically overrides, for V.I. corporations that fail either the foreign ownership test or the 20-percent of gross income test, the rule that the United States does not tax any U.S. income of V.I. inhabitants. (That rule appears in section 28(a) of the Revised Organic Act of the Virgin Islands, which ordinarily prevails over the Internal Revenue Code (Code sec. 7651(5)(B))). The effect of this overriding provision extends only to the U.S. withholding tax.

Effective Date

The provision applies to payments made after March 1, 1984.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by less than $10 million annually.

11. Taxation of Certain Transfers of Property Outside the United States (sec. 131 of the Act and secs. 367, 1492, 1494, 7477, 7482, and new sec. 6038B of the Code)[31]

Prior Law

Certain transfers of appreciated property, in the course of a corporate organization, reorganization, or liquidation, can be made without recognition of gain to the corporation involved or its shareholders. Under prior law, however, if the transfer was made out of the United States (an "outbound transfer"), a foreign corporation was not considered a corporation unless, pursuant to a request filed no later than the close of the 183rd day after the beginning of the transfer, the taxpayer established to the satisfaction of the Internal Revenue Service (IRS) that the exchange did not have the avoidance of Federal income taxes as one of its principal purposes (prior-law sec. 367(a)). Because corporate status is essential to a tax-free organization, reorganization, or liquidation, the failure to obtain a favorable ruling resulted in the recognition of gain realized by the participating corporation and shareholders. This rule prevented the tax-free removal of appreciated assets from U.S. tax jurisdiction prior to their sale without IRS review.

The types of tax-free exchanges that were subject to post-transaction clearance by the IRS were contributions of property to the capital of a controlled corporation (sec. 351), corporate reorganizations (secs. 354, 355, 356, and 361), and liquidations of subsidiary corporations (sec. 332). The prior statute authorized the Secretary to provide exceptions to the post-transaction ruling requirements.

No ruling was required for exchanges involving foreign corporations that were not treated as transfers out of the United States ("inbound transfers"). Examples of exchanges that did not require rulings were the liquidation of a foreign subsidiary corporation into a U.S. parent corporation (sec. 332) and acquisitions of stock or assets of foreign corporations in exclusively foreign transactions (secs. 351, 354, 355, or 361). With respect to these transactions, a foreign corporation was not treated as a corporation to the extent that the Secretary provided in regulations that were necessary or appropriate to prevent the avoidance of Federal income taxes. The statute contemplated that regulations promulgated with respect to this group of transactions would enable taxpayers to determine the extent, if any, to which there was immediate U.S. tax liability. Pur-

[31] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 132; H.R. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1307-1325; House floor amendment, 130 Cong. Rec. H. 2738 (April 11, 1984); "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 122; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 352-370; Senate floor amendment, 130 Cong. Rec. S. 4435-4436 (April 12, 1984); H.R. Rep. No. 98-861 (June 23, 1984), pp. 951-957 (Conference Report); and H. Con. Res. 328, 130 Cong. Rec. S. 8945 (June 29, 1984), H. 7526 (June 29, 1984).

suant to this statutory authority, temporary regulations were promulgated under which (i) a notification requirement was imposed and (ii) taxpayers were required to include in income appropriate amounts to reflect realization of gain with respect to certain transactions ("toll charge(s)") (Temp. Treas. Regs. sec. 7.367(b)-1 through 7.367(b)(12)).

Internal Revenue Service guidelines

In 1968 the IRS issued Rev. Proc. 68-23, 1968-1 C.B. 821 (the "guidelines"), setting forth the circumstances in which a ruling ordinarily would be issued that an exchange did not have the avoidance of Federal income taxes as a principal purpose.[32] The guidelines served to implement the principal purpose test of the statute. The determination of whether an exchange had the avoidance of Federal income taxes as a principal purpose depended in every case upon the particular facts and circumstances. Thus, the IRS reserved the right to issue an adverse ruling, and a taxpayer was free to establish that a favorable ruling should be issued, without regard to the guidelines.

Transfers for use in a trade or business

In the case of an exchange involving the transfer of property (other than certain "tainted assets" described below) to a foreign corporation controlled by the transferor after the transfer (a "section 351 exchange"), a favorable ruling ordinarily was issued when the transferred property was to be devoted by the foreign corporation to the active conduct of a trade or business in a foreign country. The guidelines contemplated that the foreign corporation, in addition to devoting the property to the active conduct of a trade or business, would have need for a substantial investment in fixed assets in such business or would be engaged in the purchase and sale abroad of manufactured goods.

Tainted assets

Where property falling within any of several categories of "tainted assets" was transferred to a foreign corporation, the IRS generally issued a favorable ruling only if the transferor agreed to pay a toll charge that reflected the realization of income or gain with respect to the tainted assets, regardless of whether the transfer was made for use in an active trade or business. The character of the toll charge and any basis adjustments were determined as though the tainted assets had been transferred in a taxable exchange. The categories of tainted assets included:

(1) Inventory, certain copyrights, and other property described in section 1221(1) and (3);

(2) Accounts receivable, installment obligations, and similar property with respect to which income had been earned, unless the income had been or would be included in the transferor's gross income;

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[32] Later revenue procedures and revenue rulings modified and amplified the guidelines. *See, e.g.*, Rev. Proc. 80-14, 1980-1 C.B. 617 (relating to the transfer of tangible property in a section 351 exchange, where the foreign transferee leases the property to persons who will not use the property in the United States). References to the guidelines are to the guidelines as modified and amplified.

(3) Property transferred under circumstances that made it reasonable to believe that its subsequent disposition by the transferee was one of the principal purposes of the transfer;

(4) Property leased or licensed by the transferor to a user (other than the transferee) at the time of the transfer;

(5) Property transferred under circumstances that made it reasonable to believe that the property would be leased or licensed by the transferee after the transfer; however, in the case of tangible property, a favorable ruling ordinarily was issued if the leasing of the property was part of the active conduct of a trade or business by the transferee in the foreign country, the transferee had a need for substantial investment in fixed assets in such business, and the lessee did not use the property in the United States (*See* Rev. Proc. 80-14, 1980-1 C.B. 617);

(6) Certain U.S. and foreign patents, trademarks, and similar intangibles (discussed in more detail below); and

(7) With a limited exception, stock and securities.

Treatment of stock or securities.—Under the "same country exception," a favorable ruling was issued when (1) the stock was in a foreign corporation organized under the laws of the same foreign country as the transferee, (2) immediately after the exchange the foreign corporation was 80-percent owned (within the meaning of section 368(c) of the Code) by the transferee and had a substantial part of its business assets in the country in which the transferee was organized, and (3) the transferee was 50-percent owned (as defined in section 954(d)(3) of the Code) by persons who, immediately before the exchange, controlled the transferor.

A favorable ruling was also issued where stock of a domestic corporation was acquired in exchange for stock of a foreign corporation if, immediately after the exchange, the shareholders of the acquired domestic corporation did not own (directly or indirectly) more than 50 percent of the total combined voting power of the acquiring foreign corporation. A favorable ruling was not issued, however, if the assets of the acquired domestic corporation consisted principally of stock or securities.

The case of *Kaiser Aluminum Chemical Corp.* v. *Commissioner,* 76 T.C. 325 (1981), *acq.*, 1982-2 C.B. 1, illustrated the difficulties encountered by taxpayers who sought favorable rulings on stock transfers that were made in circumstances not addressed by the guidelines. In that case, the Tax Court overturned an IRS ruling that treated stock as a tainted asset, noting that the transferred stock was closely akin to operating assets, the taxpayer's stock interest was related to its manufacturing operations as a source of supply, the stock was not liquid or readily marketable, and the stock was not a portfolio investment providing a passive return on assets.

Section 351/"B" reorganization overlap.—A tax-free transfer of stock in a foreign corporation to another foreign corporation can be characterized as either a section 351 exchange or a type "B" reorganization (generally, the acquisition of 80 percent of the stock of a corporation solely in exchange for voting stock of the acquiring corporation). Under temporary Treasury regulations, this transaction generally was treated as a type "B" reorganization, so the transaction was considered an inbound transfer (Temp. Treas. reg. sec. 7.367(b)-4(b)).

Treatment of partnerships.—Proposed Treasury regulations provided for the treatment of a transfer of property by a partnership to a foreign corporation as an indirect transfer of the property by the partners (Prop. Treas. reg. sec. 1.367(a)-1(b)(3)). The proposed regulations did not distinguish between limited and general partnerships and did not provide rules for the transfer by partners of their partnership interests.

Transfers of intangible assets.—Under the guidelines, a toll charge had to be paid to obtain a favorable ruling with respect to a transfer to a foreign corporation of a U.S. patent, trademark, or other intangible for use in connection with manufacturing for sale or consumption in the United States, or in connection with a U.S. trade or business. Thus, the transfer of U.S.-developed know-how to a tax-haven subsidiary for use in manufacturing goods for the U.S. market was subject to tax. Similarly, the U.S. holder of a trademark could not transfer it tax-free to a foreign subsidiary (which could then charge the U.S. transferor a license fee for the trademark's use in connection with a U.S. trade or business).

Under the guidelines, transfers of foreign patents, trademarks, and similar intangibles for use in connection with the sale of goods manufactured in the United States were subject to a toll charge. By implication, transfers of intangibles for use in connection with a foreign trade or business for consumption outside the United States generally were not treated as taxable.[33] Thus, U.S. persons who took advantage of tax incentives for research could transfer the fruits of that research (intangibles) to foreign corporations that could then use the intangibles free of any U.S. tax. In addition, some taxpayers took the position that the transfer of foreign patents or know-how for use in foreign manufacturing for the U.S. market was not subject to tax under the guidelines.

In the Tax Equity and Fiscal Responsibility Act of 1982, the Congress specified the extent to which income from intangibles could escape U.S. tax under the rules relating to possessions corporations. The 1982 Act, which primarily benefited Puerto Rico, treated transfers of any possession-related intangibles to foreign jurisdictions as having a principal purpose of tax avoidance.

Other areas in which a favorable ruling was conditioned on payment of a toll charge

In general, a favorable ruling was issued when assets of a domestic corporation were acquired by a foreign corporation in a corporate reorganization (secs. 354, 355, 356 and 361), provided the transferor agreed to include a toll charge in its gross income with respect to assets whose transfer in a section 351 exchange would have resulted in an unfavorable ruling. For example, if a foreign corporation acquired substantially all of the assets of a domestic corporation solely in exchange for voting stock of the foreign corporation (a type "C" reorganization) and the acquired assets included

[33] The IRS issued private letter rulings that such transfers did not have a principal purpose of tax avoidance. *See, e.g.*, LTR 8404026 (October 31, 1983); LTR 8405004 (September 29, 1983); LTR 8405113 (November 4, 1983).

a tainted asset (*e.g.*, inventory), a favorable ruling was issued (and tax-free reorganization treatment obtained) only if the domestic corporation agreed to include a toll charge in its gross income. Similarly, a favorable ruling was issued when a domestic corporation was liquidated into a foreign parent corporation, provided the domestic corporation agreed to include a toll charge in its gross income with respect to assets whose transfer in a section 351 exchange would have resulted in an unfavorable ruling. In the case of both corporate reorganizations and liquidations into foreign parents, the character of the toll charge and any basis adjustments were determined as though the property were transferred in a taxable exchange.

Use of closing agreements

Under prior law, the IRS was authorized to issue a favorable ruling under section 367 if a transferor was willing to enter into a closing agreement that obligated the transferor to pay tax on any gain from a subsequent disposition of the transferred assets by the transferee within a certain number of years after the transfer. The IRS declined to exercise this authority because of the perceived administrative burden of concluding such agreements and possible difficulties in enforcing them.

In the *Kaiser* case, the Tax Court noted the unwillingness of the Service to propose a closing agreement that specified terms and conditions for a transfer of stock subject to section 367. The court indicated that an agreement by the transferor to pay tax on a subsequent disposition of the stock by the transferee would have obviated the issue of whether the taxpayer's principal purpose was tax avoidance.

Incorporation of foreign loss branches

The transfer of the assets of a foreign branch of a U.S. taxpayer to a foreign corporation, which otherwise qualified as a tax-free contribution to the capital of the foreign corporation or as a tax-free organization, was treated as an outbound transfer. Thus, corporate status was denied to the foreign transferee unless the IRS determined that the transfer did not have the avoidance of Federal income taxes as one of its principal purposes.

Where a U.S. taxpayer operates through a foreign branch, losses incurred by the branch prior to its incorporation reduce the amount of the taxpayer's worldwide income that is subject to Federal income tax. After the branch is incorporated, generally, future income from the activity is not taken into account by the taxpayer until it receives dividends from the foreign corporation. Therefore, the guidelines required the recognition of gain on the transfer of the assets of a foreign branch to a foreign corporation, to the extent of previously deducted losses. *See* Rev. Rul. 78-201, 1978-1 C.B. 91. If the losses of the foreign branch contributed to an overall foreign loss that reduced U.S.-source income, a statutory provision could apply to require not only recognition of gain but also recharacterization of the gain as U.S.-source income (sec. 904(f)). In the case of an overall foreign loss, the amount of gain required to be recognized under the guidelines was reduced by the amount of income required to be recognized by the statutory rule.

The Tax Court, however, held that the transfer of the assets of a foreign branch to a foreign corporation did not have a tax avoidance purpose. *Hershey Foods Corp.* v. *Commissioner*, 76 T.C. 312 (1981), *gov't appeal dismissed*, No. 81-2096 (3d. Cir. 1981). In that case the court rejected the application of a tax benefit theory on the ground that there had been no recovery of an amount that was once the subject of a deduction. *But see United States* v. *Bliss Dairy Inc.*, 83-1 U.S.T.C. 9229 (U.S.), *rev'g* 645 F.2d 19 (9th Cir. 1981) (holding that the tax benefit rule may be invoked regardless of whether an actual recovery of an amount previously deducted exists).

Declaratory judgment procedure

In the case of an actual controversy involving a determination or a failure to make a determination by the IRS as to whether a transfer had tax avoidance as a principal purpose, a taxpayer could seek a declaratory judgment by the Tax Court. The Tax Court was also empowered to review any terms and conditions that the IRS sought to impose as a condition of making a determination. The Congress established this procedure because the ruling requirement prevented a taxpayer from going through with a transaction and then litigating the question of whether tax avoidance was one of the principal purposes of the transaction. Although the Congress generally approved of the standards applied by the IRS in issuing rulings, the Congress believed that there may have been cases where these standards were inappropriate or were not being correctly applied.

Under the mandatory ruling procedure of prior law, the IRS was required to issue a ruling based on whatever facts the taxpayer provided. The IRS could request additional information but could not compel its disclosure. A Tax Court declaratory judgment was based on the administrative record and was limited to a declaration of whether the IRS acted reasonably.

Judicial interpretation of the principal purpose test

The Tax Court interpreted the statute's principal purpose test to allow tax-free transfers of appreciated property to foreign corporations unless the avoidance of Federal income taxes was a purpose that was first in importance. *Dittler Bros.* v. *Commissioner*, 72 T.C. 896, 915 (1979), *aff'd mem.*, 642 F.2d 1211 (5th Cir. 1981). In *Dittler Bros.*, a U.S. corporation owned know-how for the production of rub-off lottery tickets. It transferred that know-how for 50 percent of the stock of a corporation organized in the Netherlands Antilles. The Netherlands Antilles corporation, which operated through a subsidiary, was to use that know-how in connection with foreign manufacturing for foreign markets. The other 50 percent belonged to a United Kingdom corporation that contributed marketing intangibles. Related parties were to do the manufacturing and marketing of lottery tickets for the Netherlands Antilles corporation. The Netherlands Antilles corporation operated through independent contractors and had very little in the way of fixed assets.

The IRS denied the U.S. transferor's request for a ruling that the transfer of know-how did not have as one of its principal purposes the avoidance of Federal income tax. The IRS based its denial on the failure to satisfy the guideline requirement that the transferee devote the assets to the active conduct of a trade or business and have need for fixed assets in that business. The Service's factual grounds for that denial included (1) the Netherlands Antilles corporation would not engage in any active business; rather, its income would arise from the know-how and other intangibles and rights that it received from related parties; and, (2) the arrangement created a potential for tax avoidance in that income from exploitation of the know-how was diverted to a passive recipient in a foreign tax-haven country.

Despite the active trade or business standard in the guidelines, the Tax Court held that the taxpayer was free to establish that a favorable ruling should be issued based on all the facts and circumstances. The Tax Court concluded that the transfer did not have tax avoidance as a principal purpose, based on several factors, including that (1) the U.S.'s transferor's U.K. co-owner demanded the Antilles location and the form of the transaction, and (2) there was a business reason for retention of up to 25 percent of the transferee's profits. The court did not reach the question whether transacting business through independent contractors constitutes an active trade or business.

Excise tax on certain transfers not subject to section 367

A 35-percent excise tax was imposed on certain transfers of property to foreign transferees that were not described in section 367. The excise tax was not imposed if the transferor established to the satisfaction of the IRS that the transfer was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax. In general, the excise tax applied to transfers of property by U.S. persons (including corporations and partnerships) to foreign corporations, foreign partnerships, and foreign estates and trusts. In the case of transfers of property to foreign corporations, the tax applied only to property treated as paid-in surplus or as a contribution to capital.

To the extent the transferor recognized gain on the transfer, the amount against which the tax was applied was reduced. A transferor could elect to treat a nontaxable transfer as a sale or exchange of the property and to recognize gain in the year of the transfer equal to the excess of the fair market value of the property over the transferor's adjusted basis. If gain was recognized in the year of the transfer pursuant to this election, the transfer was not subject to the excise tax.

Treatment of liquidating distributions by a domestic corporation

A liquidating distribution of appreciated property by an 80-percent-owned domestic subsidiary into its foreign parent corporation (under section 332) was treated as an outbound transfer, subject to the ruling requirement that was generally applicable to transfers of appreciated property to foreign corporations. The only statutory sanction for the failure to obtain the required ruling was the denial of the exception to the recapture rules (for depreciation, investment credits, and other items) that otherwise would be available.

Reasons for Change

The Congress originally enacted the special rules for nonrecognition transactions involving foreign corporations specifically to prevent avoidance of U.S. tax by transferring appreciated property outside the United States. Although this provision generally worked well over the years, a series of Tax Court cases threatened to weaken it.

The prior-law provisions in section 367(a) applied only to transfers pursuant to "a plan having as one of its principal purposes the avoidance of Federal income taxes." Interpreting this provision in *Dittler Bros.*, the Tax Court required that a tax avoidance purpose for a transfer be greater in importance than any business purpose before section 367(a) was applied to prevent a tax-free outbound transfer of property. This narrow interpretation by the Tax Court caused the IRS difficulty in administering section 367(a). The IRS was prevented from restricting tax avoidance transfers that the provisions of that section were intended to combat.

Transfers of intangibles

In addition to the general problems associated with judicial interpretations of the principal purpose test of section 367(a), specific and unique problems existed with respect to applying section 367(a) to the transfer by U.S. persons of manufacturing intangibles to foreign corporations. Under its published ruling guidelines, the IRS generally issued favorable rulings for transfers of patents and similar intangibles for use in an active trade or business of the foreign transferee corporation. The only exceptions were transfers of certain intangibles used in connection with a U.S. trade or business or in connection with goods to be manufactured, sold or consumed in the United States. In light of this favorable ruling policy, a number of U.S. companies adopted a practice of developing patents or similar intangibles at their facilities in the United States, with a view towards using the intangibles in foreign operations. When these intangibles were ready for profitable exploitation, they were transferred to a manufacturing subsidiary incorporated in a low-tax foreign jurisdiction (or in a high-tax jurisdiction that offered a tax holiday for specified local manufacturing operations). By engaging in such practices, the transferor U.S. companies hoped to reduce their U.S. taxable income by deducting substantial research and experimentation expenses associated with the development of the transferred intangible and, by transferring the intangible to a foreign corporation at the point of profitability, to ensure deferral of U.S. tax on the profits generated by the intangible. By incorporating the transferee in a low-tax jurisdiction, the U.S. companies also avoided any significant foreign tax on such profits.

Tainted assets

The Congress generally approved of the prior-law administrative practice of denying tax-free treatment to exchanges involving outbound transfers of liquid or passive investment assets unless the U.S. tax on the potential earnings from such assets was paid or preserved for future payment.

The Act generally codifies the tainted asset categories described in the IRS guidelines; however, the Act liberalizes the treatment of stock and securities. Stock will be considered as transferred for use in an active trade or business when transferred under circumstances similar to those of the *Kaiser* case (where the stock was akin to a direct interest in producing assets) or under certain other limited circumstances identified in regulations.

Transfers of appreciated foreign currency by U.S. businesses have increased significantly in recent years due to the increased activities of U.S. businesses in foreign countries and the substitution of floating for fixed exchange rates in 1971. Because of the obvious liquidity of foreign currency, it can easily be disposed of by a foreign transferee.

Incorporation of foreign loss branches

In certain cases, a U.S. taxpayer's foreign branch incurred losses prior to its incorporation that reduced the amount of the U.S. taxpayer's worldwide income subject to U.S. income tax. As a result of the incorporation, the income produced by these operations did not increase the amount of the U.S. taxpayer's worldwide income that was subject to U.S. income tax. The Congress concluded that the IRS position on this issue, as expressed in Rev. Rul. 78-201 and as modified by subsequent rulings, was correct. Because the Tax Court took the contrary view, the Congress believed that it was important to clarify the law to prevent future tax avoidance.

Goodwill and certain similar intangibles

Except in the case of an incorporation of a foreign loss branch, the Congress did not believe that transfers of goodwill, going concern value, or certain marketing intangibles should be subject to tax. Goodwill and going concern value are generated by earning income, not by incurring deductions. Thus, ordinarily, the transfer of these (or similar) intangibles does not result in avoidance of Federal income taxes.

Ruling requirement and declaratory judgment procedure

Standards for the issuance of rulings were well-defined through continuing administrative interpretation and practice. The development of such standards imparted a substantial degree of regularity to the ruling process. Given certain facts, taxpayers were able to predict whether the IRS would issue a favorable or an adverse ruling. Many taxpayers considered the ruling requirement burdensome, and the requirement placed a steadily increasing demand on IRS resources as outbound transfers increased in number.

The Congress believed that the elimination of the principal purpose test rendered the ruling requirement unnecessary. Accordingly, taxpayers will now be able to proceed freely with exchanges involving outbound transfers without advance or post-transaction clearance. The exchanges either will be tax-free or will involve the payment of an appropriate toll charge, in accordance with the substantive rules set forth in section 367, as amended by the Act. Taxpayers planning a transfer subject to section 367 who seek the certainty of tax treatment that a ruling provides may request a discretionary ruling regarding the tax treatment of the transfer.

The special declaratory judgment procedure of prior law was enacted because a taxpayer who received an adverse ruling could not proceed with the transaction at issue (unless the taxpayer was willing to comply with the ruling and treat the transaction as fully taxable or pay a toll charge). The Congress believed that the declaratory judgment procedure was no longer necessary in light of the elimination of the ruling requirement.

With the elimination of the ruling requirement and the declaratory judgment procedure, there was also eliminated an unintended advantage conferred on taxpayers: full control over the nature of the factual evidence upon which an IRS determination or a declaratory judgment determination under section 367 was based. Under the new discretionary ruling procedure, the IRS will decline to rule if the taxpayer does not present facts that the IRS deems sufficient to issue a ruling. Moreover, judicial review of a section 367 determination will involve a trial and full development of a factual record. That factual record will be independent of the existing administrative record; it might include information about the manner in which the exchange at issue was actually carried out (as distinguished from information about the plan for the exchange) and information about how the transferred property was used and whether the transferee disposed of it after the transfer.

So that the IRS will continue to be informed of outbound transfers of property, the Act establishes a notification requirement and a set of penalties for failure to comply with the requirement. Without a mechanism for apprising the IRS of outbound transfers, the IRS generally would have to depend on audits to detect outbound transfers of property subject to section 367 and any instances of failure to pay tax due on such transfers. Because of the complexity of many corporate income tax returns and certain exchanges that corporations carry out, the audit process is not a reliable means of isolating exchanges subject to section 367.

Explanation of Provision

Overview

The Act restructures the rules governing outbound transfers. Under the general rule, a foreign corporation is not considered a corporation for purposes of determining the extent to which gain is recognized on an outbound transfer. A general exception is provided for transfers of property for use in the active conduct of a trade or business outside of the United States. Transfers of stock, securities, or partnership interests may qualify for the exception. The Secretary of the Treasury, however, by regulations, may provide for recognition of gain in cases of transfers of property for use in the active conduct of a trade or business outside the United States. It was intended that the Secretary use this regulatory authority to provide for recognition in cases of transfers involving potential tax avoidance. The Act also authorizes the Secretary to designate other transfers that are excepted from the general rule of recognition. In addition, the Act imposes a notification requirement with respect to transfers of property outside the United States.

Certain categories of tainted assets (similar to those in the IRS guidelines) are ineligible for the active trade or business exception.

The active trade or business exception to the general rule is also inapplicable to the incorporation of certain foreign branches in circumstances where the branch has operated at a loss. Special rules are provided for the transfer of intangibles (e.g., patents, know-how, or similar items), under which the taxpayer is treated as receiving income over the useful life of the intangible in an amount reflecting reasonable payments contingent upon the productivity, use, or disposition of the intangible.

To preserve consistency between section 367(a) and the excise tax rules, the Act makes conforming changes in the excise tax provisions.

General rule

Except as otherwise provided by statute or regulation, if, in connection with any exchange described in section 332, 351, 354, 355, 356, or 361, a U.S. person transfers property to a foreign corporation, such foreign corporation is not considered to be a corporation, for purposes of determining the extent to which gain will be recognized on such transfer.[34] Except as provided in regulations, this rule does not apply to the transfer of stock or securities of a foreign corporation that is a party to the exchange or a party to the reorganization. The term "party to the exchange" as used in this provision includes a party to the reorganization (as defined in section 368(b)) and the transferor and transferee in an exchange other than a reorganization.

Exception for property transferred for use in an active trade or business

Except as provided in regulations, no gain is recognized on the transfer of property to a foreign corporation for use by such foreign corporation in the active conduct of a trade or business outside of the United States. Under the new statutory standard (which does not look to tax avoidance), a transfer such as that in *Dittler Bros.* would be taxable. The Secretary will issue regulations prescribing the standards to be used in determining whether property is transferred for use in the active conduct of a trade or business within the meaning of the Act. If regulations are not issued before January 1, 1985, it is intended that taxpayers will continue to rely on the prior IRS practice (as reflected in IRS ruling policy) in determining the existence of an active trade or business. It is expected that regulations will also address the treatment of transfers of property for use in the active conduct of a trade or business within the United States. *See, e.g.*, Treas. reg. sec. 1.367(a)-1(b)(2)(A) (providing that a domestic corporation is considered to make an outbound transfer if it transfers its property in a reorganization described in sec. 368(a)(2)(D) to another domestic corporation that is controlled by a foreign corporation).

[34] The Act clarifies the language of the prior statute: where a U.S. person transfers stock to a foreign corporation in a transaction described in section 367(a), the transferee foreign corporation—and not the corporation whose stock is transferred—loses its status as a corporation.

Treatment of stock or securities

Transfers of stock and securities that fall within the active trade or business exception can be made without the recognition of gain. Transfers of stock such as that in the *Kaiser* case (where the stock was akin to a direct interest in producing assets), will fall within the exception. The regulations implementing the active trade or business exception are expected to specify additional circumstances in which outbound transfers of stock may fall within the active trade or business exception. The Act contemplates that the guideline exceptions of prior law (*e.g.*, the "same country exception") will be retained.

Under the Act, in the case of circumstances specified in regulations (as described above) or otherwise, the IRS can condition nonrecognition treatment of the transfer of stock on the transferor's agreement that the stock will not be disposed of by the transferee (or any other person) for a substantial period of time following the year of the transfer. The transferor would be taxed on any income or gain from a disposition of the stock as if the disposition took place in the year of the original transfer at the fair market value of the stock at the time of the original transfer. Thus, interest would be added to the tax for the period from the initial transfer to the subsequent disposition. To promote compliance, the IRS might require the transferor to certify annually for some period (*e.g.*, 15 years) following the transfer that the transferred property is still held by the transferee and to file annually a waiver of the statute of limitations on assessment. In addition, the IRS might require that the transferor furnish sufficient security to ensure that any tax will be paid.

The Congress did not reverse the rule provided in Temporary Treasury regulations regarding transfers that constitute both a section 351 exchange and a type "B" reorganization. It is intended, however, that Treasury carefully reconsider whether there are cases where such a transfer should be treated as a section 351 exchange under regulations.

Partnership interests

The Act provides a special rule for transfers of partnership interests. Except as provided in regulations, an outbound transfer of a general partnership interest to a foreign corporation is treated as a transfer of the U.S. taxpayer's pro rata share of the partnership assets. Under this rule, the tax consequences of an outbound transfer of a general partnership interest will turn on whether the transfer of the underlying partnership assets would be tax-free or subject to a toll charge.

Under regulations, the rule for partnerships will not apply to most transfers of limited partnership interests. Because limited partnership interests frequently represent passive investments (comparable to stock and securities), the Act contemplates that most limited partnership interests will be treated like stock and securities for purposes of section 367. Thus, a transfer of a limited partnership interest to a foreign corporation generally will fall within the active trade or business exception only under the limited circumstances in which a transfer of comparable stock or securities would do so.

Treatment of property likely to be leased

The transfer of tangible property of a type that is leased by the transferee in the active conduct of a leasing business should generally fall within the exception provided the property transferred is not to be leased in the United States and the transferee has a need for substantial investment in the type of property transferred. *Cf.* Rev. Proc. 80-14, 1980-1 C.B. 617. (Note, however, the treatment regarding depreciation recapture discussed below.)

Tainted assets

Except as provided in regulations, gain is recognized on the transfer of (1) property described in section 1221(1) or (3) (stock in trade of the taxpayer or other property of a kind that would be included in the inventory of the taxpayer if on hand at the close of the taxable year, property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or a letter or memorandum, or similar property held by a taxpayer (a) whose personal efforts created the property, (b) for whom the property was prepared or produced, or (c) in whose hands the basis of the property is determined by reference to the basis of the property in the hands of a taxpayer described in (a) or (b)), (2) installment obligations, accounts receivable, or similar property, (3) foreign currency or other property denominated in a foreign currency, (4) certain intangible property, and (5) property with respect to which the transferor is a lessor at the time of the transfer, except where the transferee is the lessee (collectively, "tainted assets"). Tainted assets are ineligible for the active trade or business exception. Where tainted assets and other assets are transferred to a foreign corporation for use in an active trade or business, no gain will be recognized on the transfer of assets other than the tainted assets.

The Act creates a new tainted asset category: foreign currency or other property denominated in foreign currency. "Other property denominated in foreign currency" includes installment obligations, accounts receivable, accounts payable, and other obligations payable in a currency other than U.S. dollars.

The Act provides a special rule (discussed below) for transfers of certain intangibles to controlled corporations and in certain corporate reorganizations. The special rule for transfers of intangibles preempts the rule for tainted assets where property is described in both provisions. Intangibles transferred to foreign corporations in transactions that are not subject to the special rule are treated as a separate category of tainted assets.

Special rule for transfers of intangibles

Except as provided in regulations, a transfer described in section 351 of intangible property to a controlled corporation or in certain corporate reorganizations described in section 361 is treated as a sale. Intangible property is defined as any (i) patent, invention, formula, process, design, pattern, or know-how, (ii) copyright, literary, musical, or artistic composition, (iii) trademark, trade name, or brand name, (iv) franchise, license, or contract, (v) method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data, or (vi) any similar item, which property has substantial value independent of the services of any individual. Intangible property is ineligible for the active trade or business exception.

On the transfer of intangible property, the transferor is treated as receiving amounts that reasonably reflect the amounts that would have been received under an agreement providing for payments contingent on productivity, use, or disposition of the property. Amounts are treated as received over the useful life of the intangible property on an annual basis. Earnings and profits of the transferee foreign corporation are reduced by the amount of income required to be included in income by the transferor. Any amounts included in gross income by reason of this special rule are treated as ordinary income from sources within the United States.

These special rules (including the sourcing rule) apply only to situations involving a transfer of the intangible property to a foreign corporation. *See generally E. I. Dupont de Nemours & Co.* v. *United States*, 471 F.2d 1211 (Ct. Cl. 1973) (holding that the grant of a nonexclusive license with respect to a patent constituted a "transfer of property" within the meaning of section 351). in any case in which the IRS determines that an adjustment under section 482 (relating to the allocation of income and deductions among taxpayers) is appropriate because a foreign corporation obtained the use of the intangible property without sufficient compensation therefor, the special rule for transfers of intangibles will have no application to amounts included in the income of a U.S. taxpayer pursuant to such an adjustment. Thus, for example, the source of any adjustment to the income of a U.S. taxpayer under section 482 would be determined without regard to the sourcing rule in the Act. In addition, the special rule for intangibles will have no application to bona fide cost-sharing arrangements (under which research and development expenditures are shared by affiliates as or before they are incurred, instead of being recouped by licensing or selling the intangible after successful development). *See generally* Treas. reg. sec. 1.482-2(d)(4) (relating to the application of section 482 where a member of a group of controlled entities acquires an interest in intangible property as a participating party in a bona fide cost-sharing arrangement with respect to the development of such property). It is recognized that the Treasury Department may find it appropriate to elaborate on the current rules relating to cost-sharing arrangements, to adequately address arrangements with respect to intangibles.

The disposition of (1) the transferred intangible by a transferee corporation, or (2) the transferor's interest in the transferee corporation will result in recognition of U.S.-source ordinary income to the original transferor. The amount of U.S.-source ordinary income will depend on the value of the intangible at the time of the second transfer.

Incorporation of foreign loss branch

The active trade or business exception is inapplicable to the transfer of the assets of a foreign branch of a U.S. person to a foreign corporation in an exchange described in section 332, 351, 354, 355, 356, or 361. The Act requires the recognition of gain equal to the lesser of (1) the excess of pre-incorporation losses incurred by the foreign branch with respect to which a deduction was allowed to the taxpayer over the amount of any income required to be recognized by section 904(f)(3) in the current taxable year (but not amounts that were simply recharacterized as U.S.-source income under section 904(f)(1)), or (2) the gain on the transfer. In computing the tax imposed under this rule, gain on transfers of goodwill, going concern value, and marketing intangibles developed by a foreign branch will be included.

In applying the rule requiring gain recognition, a pre-incorporation loss is reduced by taxable income derived by the foreign branch in a taxable year after the taxable year in which the loss was incurred and before the close of the taxable year of the transfer. The Act provides for the characterization of the recognized gain (as ordinary income or capital gain) by reference to the character of the previously incurred losses. For example, if a branch incurred a capital loss or a foreign oil extraction loss in an earlier year, its later incorporation would yield capital gain or foreign oil extraction income, as the case may be.

On incorporation of a loss branch with appreciated intangibles, the transfer of intangibles will be subject to the special rule for intangibles, not the loss branch rule, except that gain on transfers of goodwill, going concern value, or marketing intangibles will be taxable under the loss branch rule to the extent that transfers of such property are excepted in regulations relating to the special rule for intangibles and the rule for tainted assets. In all other respects, the provision for transfers of foreign loss branches are to apply in a manner consistent with the IRS's published rulings under prior law. Thus, for example, losses that result in gain recognition on incorporation include expenses directly related to a branch's property that was not transferred but abandoned as worthless. *See* Rev. Rul. 78-201, 1978-1 C.B. 91.

Example

A taxpayer's branch in country A incurred a $100 loss in year one; that loss offset $100 of U.S. source income in year one. In year two, the taxpayer's branch in country B earned $200 of foreign source income; the taxpayer treated $100 of that income as U.S. source income pursuant to section 904(f)(1). In year three, the taxpayer incorporates the country A branch; that incorporation involves the transfer to a new country A corporation of assets with an excess of fair market value over basis of $85. In year three, none of the gain on the incorporation is required to be recognized by section 904(f)(3) as U.S. source income (because of the previous recharacterization in year two under section 904(f)(1)). Therefore, the taxpayer includes in income $85 (the lesser of the gain ($85) or the excess of the previously deducted losses ($100) over amounts subject to section 904(f)(3) ($0 in this case)) as ordinary income from sources without the United States.

Depreciation recapture

Under regulations, gain will be recognized to the extent of all depreciation deductions that the transferor previously claimed with respect to transferred property. For example, a U.S. corporation purchases an airplane for $5 million. After depreciating the airplane to zero, the U.S. corporation transfers it in a section 351 transaction to a controlled foreign corporation for use in the latter's active business overseas. The airplane's value at the time of the transfer is $8 million. The Congress intended recognition of $5 million on this transaction.

Goodwill and certain similar intangibles

The Act contemplates that, ordinarily, no gain will be recognized on the transfer of goodwill, going concern value, or marketing intangibles (such as trademarks or trade names) developed by a foreign branch to a foreign corporation (regardless of whether the foreign corporation is newly organized). Thus, where appropriate, it is expected that regulations relating to tainted assets and the special rule for intangibles will provide exceptions for this type of property. As noted above, however, no such exception will be provided under the loss branch rule. In addition, as under prior law, gain will be recognized on transfers of marketing intangibles for use in connection with a U.S. trade or business, or in connection with goods to be manufactured, sold, or consumed in the United States.

Treatment of liquidating distributions

To the extent provided in regulations to be prescribed by the Secretary, a domestic corporation recognizes gain on liquidating distributions of appreciated property to foreign persons (regardless of whether the liquidation qualifies under section 332).

Excise tax rules

To preserve consistency between the rules of section 367(a) and the excise tax rules, the Act provides that the excise tax will not apply to a transfer with respect to which the taxpayer elects, before the transfer, the application of principles similar to the principles of section 367 (including, *e.g.*, the special rule for intangibles). The Act makes conforming amendments in the excise tax provision governing abatement and refund of excise tax. Regulations implementing these provisions are to be promulgated by the Secretary of the Treasury.

Elimination of ruling requirement and repeal of declaratory judgment procedure

The Act eliminates the requirement that taxpayers planning a transfer subject to section 367(a) obtain a ruling from the IRS regarding the tax treatment of the transfer. Taxpayers may now proceed with exchanges involving outbound transfers without advance or post-transaction IRS clearance. The exchanges will be tax-free or will involve the payment of an appropriate toll charge, in accordance with the substantive rules set forth in section 367, as amended by the Act.

Taxpayers planning a transfer subject to section 367 who seek the certainty of tax treatment that a ruling provides may continue to request a ruling regarding the tax treatment of the transfer. The issuance of such a ruling will be in the IRS's discretion. Although the Act repealed the prior law rule that the IRS must issue a section 367 ruling when requested, it is expected that when facts sufficient upon which to base a ruling are provided in a ruling request the IRS normally will issue a ruling. The regularity of administrative practice under section 367 and the general codification under the Act of that practice provide sufficient certainty with respect to the tax treatment of exchanges subject to section 367 so that in many or most cases taxpayers will not consider a ruling necessary.

The Act also repeals the special declaratory judgment procedure for Tax Court review of section 367 rulings and Tax Court consideration of ruling requests.

Notification requirement

The Act establishes a notification requirement for for certain transfers to foreign persons and a set of penalties for failure to comply with the requirement. A U.S. person who transfers property to a foreign corporation in an exchange subject to section 367, or a domestic corporation that makes a liquidating distribution described in section 336 to a foreign person, is required to furnish to the Secretary such information with respect to the exchange as the Secretary may require, at the time and in the manner provided in regulations. If a U.S. person fails to comply with the notification requirement, there is imposed a penalty equal to 25 percent of the amount of the gain realized on the exchange, unless the failure was due to reasonable cause and not to willful neglect. In addition, the Act extends the general three-year limitation on assessment and collection of any tax imposed on an exchange with respect to which a taxpayer fails to give the required notice. In such a case, the time for assessment of the tax imposed does not expire before the date three years after the date the Secretary is notified. Thus, if a taxpayer fails to notify the Secretary of an exchange subject to section 367, the time for assessment of any tax imposed on the exchange by reason of section 367(a) or (d) continues indefinitely.

Effective Date

The provision generally applies to transfers or exchanges made after December 31, 1984. A transitional rule is provided for transfers or exchanges with respect to which a ruling request pursuant to section 367(a), 1492, or 1494 of the Code (as in effect before enactment of the Act) was filed with the IRS before March 1, 1984.

Special rule for certain transfers of intangibles.—There is a special rule for transfers of intangibles that occur after June 6, 1984 (the date of conference action) and before January 1, 1985 (the general effective date). Transfers of intangibles during this period will be treated as made for tax avoidance purposes. Subject to terms and conditions prescribed by the Secretary, however, the Secretary is authorized to waive the application of the special rule. It is expected that the Secretary will waive application of the rule if taxpayers agree to apply to the transfer the rules applicable to post-December 31, 1984 transfers under the Act. The Secretary may also waive application of the rule in other cases under the existing guidelines. It is intended, however, that the Secretary carefully examine transfers of intangibles before giving such a waiver. Transfers of intangibles that are not fully developed or that are not essential to the active conduct of a trade or business should not be given a waiver. This rule will not apply to transfers with respect to which a ruling request was filed before March 1, 1984, or with respect to which a ruling was obtained before June 6, 1984.

Revenue Effect

These provisions are estimated to increase fiscal year budget receipts by $12 million in 1986, $127 million in 1987, $324 million in 1988, and $540 million in 1989.

12. Provisions Relating to Foreign Personal Holding Companies (sec. 132 of the Act and secs. 551, 552, 554, and 951 of the Code)[35]

Prior Law

Foreign personal holding companies in general

Congress enacted the foreign personal holding company rules in 1937 to prevent U.S. taxpayers from accumulating income tax-free in foreign "incorporated pocketbooks." If five or fewer U.S. citizens or residents own, directly or indirectly, more than half of the outstanding stock (in value) of a foreign corporation that has primarily foreign personal holding company income (generally passive income such as dividends, interest, royalties, and rents (if rental income does not amount to 50 percent of gross income)), that corporation will be a foreign personal holding company. In that case, the foreign corporation's U.S. shareholders, including U.S. citizens, residents, and corporations, are subject to U.S. tax on their pro rata share of the corporation's undistributed foreign personal holding company income. That is, though only individuals count in the determination of foreign personal holding company status, persons other than individuals may be subject to foreign personal holding company tax.

Attribution for characterization as a foreign personal holding company

The foreign personal holding company provisions contain constructive ownership rules that determine whether a foreign corporation is more than 50 percent owned by five or fewer U.S. citizens or residents. Under prior law, these rules treated an individual as owning stock owned, directly or indirectly, by or for his or her partners, brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants. One case, however, cast doubt on the operation of these constructive ownership rules when nonresident aliens were the only family members who owned stock in a foreign corporation.[36]

These constructive ownership rules also apply to deem income to be foreign personal holding company income in two cases: (1) when

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[35] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, secs. 453 and 455; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1534-1537 and 1541-1542; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 131; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 399-404; and H. Rep. No. 98-861 (June 23, 1984), pp. 957-959 (Conference Report).

[36] In Estate of Nettie S. Miller v. Commissioner, 43 T.C. 760 (1965), nonacq., 1966-1 C.B. 4, two Canadian sisters owned over half the stock of a Canadian corporation. A divided Tax Court, despite the language of the statute, declined to attribute their stock to their brother, a U.S. citizen and resident, who owned none of the stock. Therefore, the corporation was not a foreign personal holding company, so its U.S. shareholders, who were unrelated to the Canadian sisters, were not subject to tax.

a foreign corporation has contracted to furnish personal services that an individual who owns (or who owns constructively) 25 percent or more in value of the outstanding stock of the corporation has performed, is to perform, or may be designated to perform; and (2) when an individual who owns (or who owns constructively) 25 percent or more in value of the outstanding stock of the corporation is entitled to use corporate property and when the corporation in any way receives compensation for use of that property. This latter rule prevents foreign corporations from avoiding foreign personal holding company status by generating what appear to be large amounts of rental income.

Income inclusion through foreign entity

Shareholders in a foreign personal holding company who are U.S. citizens or residents, U.S. corporations, U.S. partnerships, or estates and trusts (other than estates and trusts whose gross income includes only income from sources within the United States)[37] must include their share of undistributed foreign personal holding company income in their gross income. These shareholders are called "United States shareholders." If a foreign personal holding company is a shareholder in another foreign personal holding company, the first company includes in its gross income, as a dividend, its share of the undistributed foreign personal holding company income of the second foreign personal holding company.

Interposition of a foreign partnership, a foreign corporation other than a foreign personal holding company, or an estate or a trust whose gross income includes only income from sources within the United States between a taxpayer and a foreign personal holding company, however, arguably may have allowed avoidance of the foreign personal holding company rules under prior law. Although stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust was and is considered as being owned proportionately by its shareholders, partners, or beneficiaries for the purpose of determining whether a corporation is a foreign personal holding company, some taxpayers took the position that these tracing rules did not necessarily apply to impose a tax on the ultimate owners of a foreign personal holding company.

Coordination of subpart F with foreign personal holding company provisions

In 1962, to supplement the foreign personal holding company rules, Congress imposed tax on the U.S. shareholders of controlled foreign corporations engaging in certain tax-haven type activities by adding the Subpart F rules to the Internal Revenue Code. The Subpart F rules, as amended, impose tax when a controlled foreign corporation has "Subpart F income," and in other circumstances.

Subpart F income includes income from related party sales and services transactions through tax haven-type base companies, from insurance of U.S. risks, from shipping operations (unless the income is reinvested), from foreign oil related activities, and from

[37] This excluded category of estates and trusts corresponds generally to the definition of "foreign estate or trust" in section 7701(a)(31). Therefore, in general, estates or trusts that are U.S. persons are subject to the same treatment as U.S. citizens or corporations.

passive investments. Some of this income may also be taxable under the foreign personal holding company rules as amended. Subpart F imposes a tax (although not on "Subpart F income") in other circumstances, such as investment by a controlled foreign corporation of its earnings in U.S. property, and a controlled foreign corporation's withdrawal of its previously excluded income from shipping operations.

Where the foreign personal holding company rules and the Subpart F rules overlapped, the foreign personal holding company rules generally took priority (sec. 951(d) of prior law). A taxpayer who is subject to tax under the foreign personal holding company rules may have contended that it was not subject to the Subpart F rules that year. For instance, taxpayers (who were shareholders in a foreign corporation that was both a foreign personal holding company and a controlled foreign corporation) took the position that being subject to foreign personal holding company tax for a taxable year exempted them from taxation under Subpart F on investment that year in U.S. property of earnings of the foreign corporation. Because historical earnings invested in U.S. property, for example, might be substantially greater than current income taxed under the foreign personal holding company rules, such a position, if sustained, could have undercut much of Subpart F. Courts had split on this issue. Compare *Whitlock v. Commissioner*, 494 F.2d 1297 (10th Cir. 1974), cert. denied, 419 U.S. 839 (holding the taxpayer liable for tax under Subpart F), with *Lovett v. United States*, 621 F.2d 1130 (Ct. Cl. 1980) (holding that no Subpart F tax was due).

Same country dividend and interest rule

The controlled foreign corporation rules of Subpart F tax U.S. shareholders of controlled foreign corporations on foreign personal holding company income, with some modifications. Those rules, however, exclude from the foreign personal holding company income that is subject to Subpart F dividends and interest received from a corporation (1) related to the recipient, (2) organized in the same country as the recipient corporation, and (3) having a substantial part of its assets used in its trade or business located in that same country, as income other than investment income. This "same country exception" had no counterpart in the foreign personal holding company rules, so those rules could have applied to any dividends or interest. However, a threshold test applies, so that, in some cases, so long as less than 60 percent of a foreign corporation's income is foreign personal holding company income, it will not be a foreign personal holding company.

Reasons for Change

The foreign personal holding company provisions have been in the law since 1937 and serve an important purpose in removing the tax incentive to shift assets offshore, often to tax havens. Several technical problems with the provisions came to Congress' attention.

First, Congress amended the attribution rules in accordance with its belief that attribution of ownership from a nonresident blood relative for the purpose of determining whether a foreign corporation is a foreign personal holding company is generally inappropriate where the U.S. person to whom the stock would be attributed owns no stock. At the same time, Congress saw the possibility of significant abuse when a nonresident alien and his or her U.S. blood relative own stock in a foreign corporation, so the Act provides that attribution will occur if and only if both the nonresident alien and his or her relative own stock. Congress did not intend any inference about prior law attribution rules governing cases of blood relatives. Similarly, Congress decided that there should be no such attribution from a nonresident alien partner in a partnership in which no U.S. shareholder is a partner (so long as the alien's partners do not include members of a U.S. shareholder's family).

In addition, Congress was aware that the prior rules allowed taxpayers to take the position that they could circumvent the foreign personal holding company rules by interposing foreign entities between themselves and foreign personal holding companies. This abuse of the system was not intended and Congress needed to clarify the law to stop this abuse. Congress chose as its model for the new foreign personal holding company look-through rules the existing controlled foreign corporation rules. Congress intended these new look-through rules to apply to include income in the hands of shareholders of foreign personal holding companies who are not subject to the controlled foreign corporation rules of subpart F, because for example, they are not 10-percent U.S. shareholders.

Moreover, it came to Congress' attention that the Code provision governing the overlap of the Subpart F and foreign personal holding company rules produced uncertainty and some questionable results. Congress believed that U.S. taxpayers should be subject to tax on the full amount of the tainted earnings of their foreign corporations, not more and not less. However, Congress intended no inference as to the proper result under prior law.

Finally, Congress believed, because there appears to be no shifting of income to a tax haven when a foreign personal holding company receives interest or dividends from a related corporation organized and operating in the same country, that such income should not be foreign personal holding company income. In connection with the factoring provision (sec. 123 of the Act), however, Congress expressed concern that the same country interest rule could improperly allow reduction of income that should be subject to an anti-abuse rule (the foreign personal holding company rules or subpart F). In any event, Congress did not believe that same country interest or dividends should count as non-foreign personal holding company income, because such treatment could sometimes insulate other passive income from tax by avoiding the threshold for foreign personal holding company status.

Explanation of Provisions

Attribution rules for characterization as a foreign personal holding company

The Act provides, for the purpose of determining whether five or fewer U.S. citizens or residents own, directly or indirectly, more than half of the outstanding stock (in value) of a foreign corporation, that ownership of stock actually owned by a nonresident alien will be attributed to to the alien's U.S. brothers and sisters (whether by the whole or half blood), ancestors, and lineal descendants who own stock in the foreign corporation. Conversely, for that purpose, ownership of stock actually owned by a nonresident alien will not be attributed to to the alien's U.S. brothers and sisters (whether by the whole or half blood), ancestors, and lineal descendants who do not own stock in the foreign corporation. For example, under the Act, a foreign corporation 40 percent of whose shares belong to a U.S. citizen and 60 percent of whose shares belong to the nonresident alien sister of the U.S. citizen will be a foreign personal holding company if it meets the other criteria for foreign personal holding company status.

The Act also repeals the rules that attributed ownership of stock actually owned by a nonresident alien to the alien's U.S. partners, but the repeal is effective only if the alien's U.S. partners do not own, directly or indirectly, stock in the foreign corporation and so long as the alien's partners do not include members of the same family as a U.S. citizen or resident who owns, directly or indirectly, stock in the foreign corporation. For example, if the nonresident alien partner of a U.S. citizen owns 60 percent of a foreign corporation, while a second U.S. citizen (who is wholly unrelated to the first U.S. citizen and to the nonresident alien) owns the remaining 40 percent, the foreign corporation is not a foreign personal holding company. The Act will not affect the current attribution rules that operate to treat certain income from personal services and income from certain use of corporate property as foreign personal holding company income.

Income inclusion through foreign entity

The Act adds a tracing rule that makes it clear that taxpayers cannot interpose foreign corporations (other than foreign personal holding companies), foreign partnerships, estates or trusts whose gross income includes only income from sources within the United States, or other entities between themselves and the foreign corporation to avoid the foreign personal holding company rules. The Act provides that stock of a foreign personal holding company that is owned by a partnership, estate, or trust that is not a U.S. shareholder, or by a foreign corporation that is not a foreign personal holding company, is considered (for income inclusion purposes) as being owned proportionately by its partners, beneficiaries, or shareholders. This rule applies to trace ownership and attribute income through tiers of such entities. The Act grants regulatory authority to the Secretary of the Treasury to provide for such adjustments in the foreign personal holding company rules as may be necessary to carry out the purposes of this rule. Congress granted this regulatory authority because it foresaw that such an adjustment could be necessary to prevent double taxation of foreign personal holding company income in the case of shares held through a foreign corporation.

This situation could arise in a case where a U.S. person owns shares in a foreign corporation that is not a foreign personal holding company that in turn owns stock in a foreign corporation that is a foreign personal holding company. Under the Act, the U.S. person could be subject to tax on his pro rata share of the income of the foreign personal holding company and, unless an adjustment were made, could be subject to tax again upon a dividend distribution from the same earnings from the foreign personal holding company which, in turn, is redistributed as a dividend by the foreign corporation to the U.S. shareholder. Congress intended that rules similar to those contained in section 959 apply.

Congress intended that, as under prior law, to the extent that the grantor of (or a transferor to) a trust is taxable on its income, then that person (and not a beneficiary of the trust) will be treated as the owner of the trust for the purposes of the foreign personal holding company rules. For example, the grantor of a revocable trust is taxable on its income (sec. 674); the grantor is considered its owner for the purposes of the foreign personal holding company rules.

Coordination of subpart F with foreign personal holding company provisions

The Act repeals the rule of section 951(d) that taxation under the foreign personal holding company rules precludes taxation under the Subpart F rules. It substitutes a new mechanism for the avoidance of double taxation by providing that a controlled foreign corporation's Subpart F income is taxed under Subpart F—but not under the foreign personal holding company rules—to the extent that it would otherwise be taxable under both Subpart F and the foreign personal holding company rules. Therefore, the existence of income subject to tax under the foreign personal holding company rules does not preclude taxation under Subpart F. Income includible under only one set of rules (foreign personal holding company rules or Subpart F rules) is includible under that set of rules. A taxpayer taxable under Subpart F on amounts other than Subpart F income (on such items as withdrawals from foreign base company shipping income and investments in U.S. property) is taxable under Subpart F whether or not its foreign corporation subjected it to foreign personal holding company tax.

Same country dividend and interest rule

For purposes of the foreign personal holding company rules, dividends and interest received from a corporation (1) related to the recipient, (2) organized in the same country as the recipient corporation, and (3) having a substantial part of its assets used in its trade or business located in that same country generally do not count in determining whether a foreign corporation is a foreign personal holding company—either as foreign personal holding company income or as non-foreign personal holding company income. That is, such income does not generally enter into the numerator or the denominator of the threshold fraction used to determine whether a corporation is a foreign personal holding company. In addition, such dividends and interest are generally not treated as foreign personal holding company income that is taxable to the U.S. shareholder of a foreign personal holding company. However, this exclusion will not apply to dividends or interest from a corporation that is a foreign personal holding company (without regard to such payments), because such payments could reduce the amount subject to the foreign personal holding company tax on account of the payor without creating an inclusion on account of the payee.

Effective Date

The amendments to the foreign personal holding company attribution rules and the interposed-entity look-through rules apply generally to taxable years of foreign corporations beginning after December 31, 1983. However, the rule relating to interposed foreign entities will apply to taxable years of foreign corporations beginning after December 31, 1984, with respect to certain stock of foreign corporations owned by certain pre-1954 trusts none of whose beneficiaries were U.S. citizens or residents at the time of creation or for five years thereafter and that make only formal changes in their holdings after July 1, 1983. The provision extending the same country dividend and interest exception to foreign personal holding companies applies to taxable years of U.S. shareholders beginning after the date of enactment (July 18, 1984). The amendment to the provision governing the overlap of the Subpart F rules and the foreign personal holding company rules (section 951(d) applies to taxable years of U.S. shareholders beginning after the date of enactment.

Revenue Effect

The provision is estimated to increase budget receipts by less than $5 million annually.

13. Gain From Sale or Exchange of Stock in Certain Foreign Corporations (sec. 133 of the Act and secs. 959 and 1248 of the Code)[38]

Prior Law

Under prior-law section 1248, gain recognized on the sale or exchange of stock in a foreign corporation by a U.S. person owning ten percent or more of the corporation's voting stock could be treated as a dividend. This rule was designed to prevent U.S. taxpayers from accumulating earnings free of U.S. tax in a controlled foreign corporation (generally, a foreign corporation more than 50 percent of the voting stock of which is owned by U.S. persons who own ten percent or more of such stock, referred to as a "CFC"), and then (rather than repatriating the earnings in the form of dividends taxable as ordinary income) disposing of the stock at capital gain rates for a price that reflects the accumulated earnings. The statute recharacterized gain as dividend income to the extent of the corporation's post-1962 earnings and profits ("E&P") attributable to the period the stock sold was held by the shareholder while the corporation was a CFC.

The Tax Reform Act of 1976 extended the rule for dispositions of stock in a foreign corporation to various nonrecognition transactions involving U.S. corporations. Under the 1976 amendment, a U.S. corporation that disposed of stock in a transaction governed by section 311, 336, or 337 (by distributing the stock as a dividend-in-kind or in the course of liquidation) generally was required to recognize its pro rata share of post-1962 E&P as dividend income. The amount of dividend income required to be included in the U.S. corporation's income was equal to the difference between the fair market value of the stock and its basis, subject to the post-1962 E&P limitation.

Under the 1976 amendment, no amount was includible in income as a dividend if stock in a foreign corporation was distributed to a domestic corporate shareholder that was treated as holding the stock during the period for which the stock was held by the distributing corporation, and certain stock-ownership requirements were met (sec. 1248(f)(2)). Under prior law, this exception generally applied where stock was distributed in a nonliquidating or liquidating distribution and the corporate distributee's basis in the stock was determined by reference to the basis of the stock in the hands of the distributing corporation immediately before the distribution.

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[38] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, secs. 133 and 454; H.R. Rep. No. 98-432, Pt. 2 (March 5, 1984) pp. 1326-1328 and 1538-1540; Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 123; S. Prt. 98-169, Vol. I (April 2, 1984) pp. 371-373; and H.R. Rep. No. 98-861 (June 23, 1984), pp. 959-960 (Conference Report).

Certain indirect transfers

Taxpayers took the position that section 1248 did not apply if a CFC that was wholly owned by a widely held U.S. corporation issued new shares and paid a small amount of cash in exchange for shares representing a majority interest in the U.S. corporation. If this interpretation were sustained, the shareholders of the U.S. corporation would pay a capital gains tax on the difference between the value of the foreign corporation's stock (plus the cash) and their basis in the stock in the U.S. corporation, but no ordinary income tax would be paid on the accumulated E&P of the CFC at that time. Further, because the transaction would result in the foreign corporation ceasing to be a CFC, earnings accumulated prior to the exchange could avoid the U.S. corporate-level tax. No inference is intended that the transaction worked as described.

Double counting

The Internal Revenue Service held that the E&P of a CFC are not reduced by the amounts that are treated as dividends by virtue of the application of section 1248. Rev. Rul. 71-388, 1971-2 C.B. 314; *but see* Rev. Rul. 83-182, 1983-2 149 (which ruling suspended Rev. Rul. 71-388 on this point). Thus, a subsequent distribution by the foreign corporation could have been treated as a dividend out of E&P that had already caused a dividend inclusion. The new owner also could claim that it was entitled to foreign tax credits for taxes imposed on the foreign corporation with respect to the previously taxed E&P, even if the former shareholder already had claimed a credit for such taxes.

Indirect ownership

Some taxpayers took the position that they could avoid the application of section 1248 by a series of transactions involving related parties. The first step in this series was the contribution of the stock in a first-tier CFC of a U.S. parent corporation to another first-tier CFC of the U.S. parent. The second step was the sale or exchange of the stock of the second CFC. Taxpayers contended that E&P accumulated by the first CFC before the contribution of its stock to its affiliate did not require dividend treatment of amounts received by the U.S. parent on disposition of stock in the affiliate. This position was based on the view that a cross reference in prior-law section 1248(c)(2)(D)(ii) indicated that E&P accumulated during direct ownership is not taken into account when a U.S. person disposes of an interest held indirectly through a subsidiary.

Reasons for Change

The purpose of the provision that recharacterizes gain upon the sale or exchange of stock in certain foreign corporations is to tax the accumulated profits of active foreign corporations upon repatriation. Although section 1248 has generally carried out this policy, certain transactions arguably circumvented the statutory rules. In the view of the Congress, the ability to avoid ordinary income tax by causing a foreign corporation to engage in a transaction with the shareholders of its U.S. parent corporation would undermine the principle of taxing accumulated earnings and profits of foreign corporations upon repatriation. A U.S. corporation should be required to recognize dividend income upon the acquisition of its stock in exchange for stock of its wholly owned foreign corporation. This treatment is also appropriate in certain cases where a U.S. corporation owns less than 100 percent of a foreign corporation that is or was a CFC. The Congress was aware that prior law was unclear, and no inference is intended that these transactions worked as described.

The Congress was also concerned about the technical problems relating to changes that were made in the Tax Reform Act of 1976. The Congress believed that the prior-law rules were unclear, causing hardship in some cases while giving unintended tax advantages in others.

Explanation of Provision

Overview

In certain cases, the Act requires a U.S. corporation to recognize dividend income on the acquisition of its stock by a foreign corporation that is or was a related CFC. The Act also prevents the double counting of E&P as the result of the application of section 1248. In addition, the Act treats a U.S. person's indirect ownership of a CFC like direct ownership.

Certain indirect transfers

Under the Act, if shareholders of a U.S. corporation exchange stock in the U.S. corporation for newly issued stock (or treasury stock) of a foreign corporation ten percent or more of the voting stock of which is owned by the U.S. corporation, the transaction is recast. For purposes of applying section 1248, the foreign corporation is viewed as having issued the stock to the U.S. corporation and the U.S. corporation is treated as having distributed that stock to its shareholders. Under the rules of section 1248 provided in prior law, the U.S. corporation is thereby required to recognize dividend income (unless a statutory exception applies). The amount of dividend income is equal to the difference between the fair market value of the stock in the foreign corporation received by the shareholders of the U.S. corporation and the U.S. corporation's basis for the stock, subject to the post-1962 E&P limitation.

The Congress intended that, where applicable, the exception for distributions to a domestic corporate shareholder in section 1248(f)(2) apply to indirect transfers that are recast under the special rule. Under another provision of the Act, however, a distributing corporation generally will be required to recognize gain on nonliquidating distributions of appreciated property to corporate shareholders (under sec. 311). Where this result occurs, the distributee corporation's holding period for distributed stock will begin on the date of the distribution and, thus, the exception in section 1248(f)(2) will be unavailable. Corporations that distribute appreciated stock in liquidating distributions will continue to enjoy nonrecognition treatment under section 336. Thus, where an indirect transfer is properly recast as a liquidating distribution, the section 1248(f)(2) exception will apply with respect to stock received by a domestic corporate shareholder that is treated as holding the stock during the period for which the stock was held by the distributing corporation.[39]

The application of this provision is illustrated by the following example:

Example (pre-enactment)

M, a U.S. corporation, is and always has been the sole shareholder of P, a foreign corporation. P, which was organized in 1959, has previously untaxed post-1962 earnings and profits of $40 million. M, whose shares are widely held, has assets worth $100 million (including P shares representing $40 million of value). In recent years, while profits from M's operations have declined, P's foreign operations have generated substantial income. M has a zero basis in the P stock. In addition, many of M's shareholders have losses in their M stock. M's shareholders transfer all of their stock in M to P in exchange for newly issued P stock representing 90 percent of the total number of shares of outstanding P stock plus a de minimis amount of cash. After the exchange, P owns all of the outstanding stock of M, and the former M shareholders own stock of P with a value approximating $100 million. The principal purpose of this transaction was to enable the corporate group to retain and reinvest P's accumulated and future foreign earnings free of U.S. tax.

On the basis of public and private rulings issued by the Internal Revenue Service and cases decided under the law in effect prior to enactment of the Internal Revenue Code of 1954, the parties to the transaction could take the position that the former M shareholders acquired all the P stock received by them in exchange for M stock worth approximately $100 million, notwithstanding the fact that P's value was augmented by only $60 million dollars. *See* Rev. Rul. 84-30, 1984-9 I.R.B. 5; Rev. Rul. 57-465, 1957-2 C.B. 250; *Helvering* v. *Schoellkopf*, 100 F.2d 415 (2d Cir. 1938). *But see Bausch & Lomb Optical Co.* v. *Commissioner*, 267 F.2d 75 (2d Cir. 1959), *cert. denied*, 361 U.S. 835 (1959) (where a corporation that issued its stock in exchange for all the assets of its 79-percent owned subsidiary was treated as receiving the assets in consideration for its stock in the subsidiary by way of liquidation—to the extent of the 79-percent stock interest—rather than in a tax-free reorganization).

The Act taxes the transaction in accordance with its economic substance. The effect of the Act is to treat the excess of the value held by the former M shareholders after the exchange ($100 million) over the amount by which P's value was augmented ($60 million) as if M had distributed P shares equal to that difference ($40 million in the example) to its shareholders. Under the 1976 amendments to section 1248, M would recognize ordinary income of $40 million if the P stock were distributed as a dividend-in-kind or in liquidation (except to the extent that a statutory exception applied). Similarly, under the Act, $40 million is includible in M's income as a dividend.

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[39] Because the statute refers to a distribution by a 10-percent corporate shareholder "in redemption" of stock, it is arguable that every indirect transfer should be recast as a nonliquidating distribution (subject to section 311), even if the corporation that is deemed to distribute the stock goes out of existence (and the transaction has the effect of a liquidation to which section 336 should apply). The Congress intended to tax an indirect transfer in accordance with its economic substance.

Double counting

To the extent that accumulated E&P previously resulted in characterization of income as a dividend, the E&P will be treated as previously taxed income. Thus, if a U.S. corporation distributes the stock of a CFC in a complete liquidation, the amount of any dividend income generated by the liquidation will be treated as previously taxed income out of the E&P of the CFC. The same result obtains if a U.S. person sells its interest in a CFC and recognizes dividend income. The Act also clarifies that, in any case, a new shareholder is not entitled to claim a foreign tax credit for taxes imposed on the foreign corporation with respect to the previously taxed E&P.

Indirect ownership

The Act clarifies prior law to provide that E&P accumulated by a foreign corporation while the corporation was controlled by U.S. persons is taken into account under section 1248, regardless of whether the U.S. persons controlled the corporation directly or indirectly.

Effective Date

The provision to apply section 1248 to certain indirect transfers is effective for exchanges after the date of enactment of the Act (July 18, 1984).

The technical amendments apply to sales or exchanges of stock that occur after the date of enactment. The Act provides an election to apply the double-counting provision to transactions occurring after October 9, 1975 (the effective date of certain amendments to section 1248). For sales or exchanges of stock in foreign corporations, a foreign corporation (or its successor in interest) is eligible to make the election. If a foreign corporation that would be eligible to make the election has been liquidated by the date of enactment or within the election period, its successor in interest is determined under rules similar to rules provided under section 964. In the case of a section 311, 336, or 337 transaction involving a U.S. corporation that distributes stock of a CFC, the distributing U.S. corporation or its successor is eligible to make the election. In either event, the election applies to all eligible post-October 9, 1975 transactions of the electing corporation. The corporation is to make the election within 180 days after the date of enactment.

Revenue Effect

These provisions are estimated to increase fiscal year budget receipts by less than $10 million annually.

14. Foreign Collapsible Corporations (sec. 135 of the Act and sec. 341 of the Code)[40]

Prior Law

Overview

The collapsible corporation rules of section 341 are designed to prevent the use of a specific tax-avoidance device: the use of a corporation to convert business profits that would otherwise be taxed as ordinary income to capital gain. Under prior law, Congressional intent underlying section 341 could be circumvented in some circumstances by use of a foreign corporation.

Background

The reports of the Committee on Ways and Means and the Committee on Finance that accompanied the 1950 legislation enacting section 341 describe a collapsible corporation as "a device...used in an attempt to convert ordinary income into long-term capital gain by use of a temporary corporation."[41]

Because U.S. persons are subject to Federal income tax on their worldwide income, there was an incentive to make use of collapsible corporations to engage in activities conducted abroad, as well as activities conducted within the United States.

Statutory rules and legislative history

General rules

The efficacy of the collapsible corporation as a tax-avoidance device depends on the combination of two tax results: (1) avoiding a tax at the corporate level and (2) obtaining capital gain treatment at the shareholder level. In 1950, Congress acted to prevent taxpayers from obtaining the combination of tax results that underlies the utility of a collapsible corporation.

Section 341(a) generally treats a shareholder's gain on the sale or exchange of stock in a collapsible corporation as ordinary income. Section 341(b)(1) defines the term collapsible corporation to include a corporation that is formed or availed of principally for the manufacture, construction, or production of property, with a view to a sale or exchange of stock by its shareholders before the realization by the corporation of a substantial part of the taxable income to be derived from the property, and the realization by the shareholders

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[40] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 138; H. R. Rep. No. 98-432, Pt. 2 (March 5, 1984); Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 126; S. Prt. 98-169, Vol. I (April 2, 1984); and H.R. Rep. No. 98-861 (June 23, 1984), pp. 961-964 (Conference Report).

[41] H.R. Rep. No. 2319, 81st Cong., 2d Sess. 196 (1950); S. Rep. No. 2375, 81st Cong., 2d Sess. 88 (1950).

of the gain attributable to the property. Thus, the statutory definition of a collapsible corporation looks to whether a corporation can be expected to realize the gain inherent in its property in the normal course of business.

The provisions of section 341 made no distinction between domestic corporations and foreign corporations. Thus, the collapsible corporation rules applied to a foreign corporation that was used as the vehicle for the proscribed tax avoidance scheme. Rev. Rul. 56-104, 1956-1 C.B. 178.[42]

Section 341(e) exceptions for nonabusive situations

In 1958, the Congress refined the collapsible corporation rules to provide exceptions for situations that were not intended to be covered by the initial legislation. The report of the Senate Finance Committee acknowledged that "the purpose of [section 341]...is to prevent income which would otherwise be taxed at ordinary income rates from being converted into income taxable at capital gain rates merely by use of the corporate entity."[43] The statutory definition of collapsible corporation, however, by its terms and as interpreted, could result in the application of section 341 to tax a shareholder's gain as ordinary income even if the corporation's property would constitute a capital asset in the hands of the shareholder.[44] The 1958 legislation, which added section 341(e) to the Code, was designed, in part, to reverse this result.

The facts of Revenue Ruling 72-24, 1972-1 C.B. 103, disclosed that a foreign corporation was a collapsible corporation within the meaning of section 341(b). Section 341 was not applied, however, because of the application of section 341(e). In applying section 341(e), the Internal Revenue Service treated the foreign corporation as if it were a domestic corporation.

Section 341(f) consent to recognize gain at the corporate level

Section 341(f)(1) permits capital gain treatment on disposition of stock in a collapsible corporation if the corporation consents to recognize gain on the disposition of its "subsection (f) assets" (generally, assets other than capital assets) when realized, even in a transaction that would otherwise qualify for nonrecognition of gain. Section 341(f)(3) provides an exception to the requirement of corporate-level gain recognition for certain tax-free corporate organizations, reorganizations, and liquidations, if the transferee gives a section 341(f)(1) consent.

The theory of section 341(f) is that section 341 should not apply if the corporation continues in existence and realizes the gain on its property.[45] To insure the result on which section 341(f) is premised,

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[42] The Congress has addressed the issue of the extent to which U.S. taxpayers can use foreign corporations to defer U.S. tax on foreign-source income in sections 951-964 of the Code ("Subpart F"); it has addressed the use of foreign corporations to convert ordinary income to capital gain in section 1248 of the Code. Under these provisions, the earnings and profits of certain foreign corporations are taxed as ordinary income to U.S. shareholders who own ten percent or more of the corporation's stock. Because the classic collapsible corporation has insignificant earnings and profits, neither Subpart F nor section 1248 prevents the use of a foreign corporation for the proscribed device.

[43] S. Rep. No. 1983, 85th Cong., 2d Sess., 31 (1958).

[44] *See Braunstein* v. *Commissioner*, 347 U.S. 65 (1963) (holding that there is no implied exception for this situation).

[45] H. R. Rep. No. 1308, 88th Cong., 2d Sess., 3 (1964).

the statute mandates recognition of gain on dispositions that would otherwise be tax-free.

Treasury regulations provided that, in the case of a foreign corporation that gives a section 341(f) consent, any gain on the corporation's disposition of a subsection (f) asset is considered gross income that is effectively connected with a U.S. trade or business (Treas. Reg. sec. 1.341-7(e)(3)). A foreign corporation is subject to the regular corporate income tax with respect to income that is effectively connected with a U.S. trade or business. The regulatory provision may have no practical effect, however, where the foreign corporation's income is not subject to U.S. tax (because the corporation has no U.S.-source income and is not engaged in a U.S. trade or business) and the stock is sold to a foreign person.

Reasons for Change

There is no policy reason to allow the use of the collapsible corporation device by U.S. taxpayers simply because the corporation is organized under the laws of a foreign country to engage in an activity abroad. This result could occur, however, where the stock of a foreign collapsible corporation was sold to a foreign person and the section 341(f) consent procedure was used.

Congress was aware that some taxpayers took the position that section 341 should not apply to a foreign corporation that derives no U.S.-source income, and that section 341(f) properly provided a means to accomplish this result. This position was premised on the notion that the primary purpose of section 341 is to insure the collection of a Federal corporate income tax. To the contrary, the legislative history makes clear that section 341 was designed to prevent the conversion of ordinary income to capital gain by use of a corporation; the avoidance of tax at the corporate level was incidental to the conversion technique. Thus, the fact that the income of a foreign collapsible corporation is not subject to U.S. tax does not present a reason to permit the corporation's shareholders to circumvent section 341 by use of a section 341(f) consent.[46]

Explanation of Provision

Under the Act, a section 341(f) consent given by a foreign corporation will not be given effect. Thus, a section 341(f) consent will not be given effect if the consenting corporation is not engaged in a U.S. trade or business and stock in the corporation is sold to a foreign person. Similarly, the exception to the requirement of corporate-level gain recognition (in section 341(f)(3)) does not apply if the transferee is a foreign corporation.

Congress recognized that there may be cases in which a section 341(f) consent given by a foreign corporation should be given effect. Accordingly, the Act authorizes the Secretary to prescribe regulations setting forth circumstances in which it would be appropriate to give effect to a section 341(f) consent given by a foreign corporation.

[46] The Congress acknowledged that it may be appropriate to review the relationship among the Subpart F provisions, section 1248, and section 341.

Effective Date

The amendment to section 341 took effect on the date of enactment of the Act (July 18, 1984).

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by less than $10 million annually.

15. Stapled Stock; Stapled Entities (sec. 136 of the Act and new sec. 269B of the Code)[47]

Prior Law

Taxpayers had entered into arrangements wherein the stock of two (or more) entities was "stapled" or "paired" so that shareholders could not trade the stocks separately. Typically, however, the management of the stapled-stock entities was the same.

Foreign corporations whose shares are sufficiently dispersed among U.S. persons were not and are not subject to certain U.S. tax rules. The anti-tax-haven rules of subpart F of the Code and the anti-international boycott rules apply to foreign corporations only if more than 50 percent of the total combined voting power of their stock is owned (directly or indirectly) by U.S. shareholders owning at least 10 percent of the stock each. The foreign personal holding company rules apply only if more than 50 percent of a corporation's outstanding stock (in value) is owned (directly or indirectly) by five or fewer U.S. shareholders. Certain widely-held U.S. corporations attempted to avoid these rules by splitting off their foreign operations and conducting them through separate corporations.

The stock of the foreign corporation was "stapled to" or "paired with" the stock of the original U.S. company so that a shareholder could not buy or sell the stock of one corporation without buying or selling the stock of the other. Assuming the U.S. corporation was sufficiently widely held, this device arguably reached the result that the new foreign corporation was not subject to the subpart F and anti-boycott rules because the 10-percent shareholder test was not met. This device may similarly have allowed avoidance of the foreign personal holding company rules. It is not clear, however, that these split-offs had the tax consequences that these U.S. corporations sought. Although there was authority that would have tended to support the integrity of these split-offs, see, e.g., Rev. Rul. 54-140, 1954-1 C.B. 116, other authority indicated that the courts would not respect the formation of such a "quasi-subsidiary," (e.g., *De Coppet v. Helvering,* 105 F.2d 787 (2d Cir. 1940), *cert. denied*, 310 U.S. 646).

In addition, stapling of stock of two or more U.S. corporations could have allowed shareholders to benefit from multiple surtax exemptions and from multiple accumulated earnings tax credits. Also, one stapled entity may have qualified for special tax treatment as a Real Estate Investment Trust (REIT) or a Regulated In-

[47] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 456; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1543-1547; H. Rep. No. 98-861 (June 23, 1984), pp. 964-965 (Conference Report); and H. Con. Res. 328, 130 Cong. Rec. S. 8945 (June 29, 1984), H. 7526 (June 29, 1984).

vestment Company (RIC). This special treatment would not have been available if the operations of the companies had been consolidated.

Finally, in these examples, and potentially in other cases where tax benefits among related parties are limited or where tax penalties may be imposed on related parties, companies may have used stapled stock to appear to be unrelated.

Reasons for Change

Congress believed that the stapling of corporate stock was a simple means of attempting to avoid tax rules intended to limit abuse of the U.S. tax system and to limit the use of special tax benefits granted by Congress. Stapling of a taxable entity with a nontaxable entity was a particularly serious problem. In such a case, the shareholders (who were the same for both corporations) generally preferred profits to be realized in the nontaxable entity rather than in the taxable entity. Congress believed that to permit the use of such a transparent device would have weakened the integrity of the tax system.

Transfer pricing.—Shareholders of stapled stock may have had no business reason to complain if their taxable entity undercharged their nontaxable entity for goods or services.[48] If stock is not stapled, by contrast, the shareholders of a company can sue its management (in a shareholders' derivative suit) if the company undercharges another entity. Although the United States has the right to correct improper transfer prices between related parties (sec. 482), this is a complicated and difficult issue.[49]

The problem of transfer pricing also arises on stapling of a U.S. corporation with a foreign corporation operating in a low-tax jurisdiction or in a tax haven. The problem of transfer pricing also arises on stapling of a special-purpose U.S. entity with another U.S. corporation. For instance, an ordinary corporation stapled to a Real Estate Investment Trust (REIT) that leases real property from the REIT may not object to a premium rental price, because the non-REIT's profits are subject to corporate tax while the REIT's are not.

Stapled foreign entities.—Stapling may also allow avoidance of the anti-tax-haven rules and the anti-boycott rules. Improper avoidance of these rules may occur if a stapled foreign entity is widely held, because the rules apply only in cases of relatively concentrated ownership. Stapling also can allow a U.S. company establishing foreign operations to avoid the U.S. corporate tax on dividends received from a subsidiary by establishing a stapled sister corporation rather than a subsidiary.

Stapled U.S. entities.—Congress believed that stapling special purpose U.S. tax entities to ordinary U.S. entities was not in accord

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[48] If a U.S. corporation owns equal interests in a U.S. corporation and a nontaxed foreign corporation, it may prefer to have the next dollar of earnings go to the U.S. corporation (in which it owns stock) rather than the foreign corporation. If the effective U.S. tax rate (on the income of the corporation earning the marginal income) is low, the 85-percent dividends received deduction may outweigh the benefits of deferral for the U.S. corporate shareholder.

[49] See Comptroller General of the United States, Report to the Chairman, House Committee on Ways and Means, "IRS Could Better Protect U.S. Tax Interests in Determining the Income of Multinational Corporations," September 30, 1981.

with the policy that led Congress to create those special purpose U.S. tax entities. For example, Congress granted special tax status to corporations that qualify as REITs to allow passive investments in real estate without an entity-level tax. This result is achieved by, in substance, treating the REIT as a flow-through entity. Congress believed that, when a REIT and an active business are stapled, there is one investment, not two, and that the one investment is in an active business. Therefore, Congress believed that the corporate tax should not be eliminated. If separate tax treatment were recognized for a REIT that is stapled to an active business, the net effect would be to eliminate the corporate tax on the income from the real estate. In enacting the special provisions for REITs, Congress did not intend to eliminate the corporate tax on the portion of an active business' income that arises from the ownership of its real estate. Moreover, where the real estate is leased by the stapled REIT to the active business, any income from that real estate is not passive, but is part of the business' active income. If investors buy shares in another corporation stapled to REIT shares, active business income may improperly benefit from pass-through treatment.

In addition, stapling arguably allowed taxpayers multiple surtax exemptions and multiple accumulated earnings tax exemptions. Congress believed that such multiple exemptions were inappropriate.

Unusual circumstances.—Congress took notice of some unusual circumstances involving stapled stock. Congress believed that the United States should not tax a REIT stapled at the time of introduction of H.R. 3475, the bill whose stapled stock provision became part of the Act, because the Internal Revenue Service, in several private letter rulings, explicitly sanctioned stapling of REITs. Congress also believed that the United States should not tax a stapled foreign corporation on income that was exempt from U.S. income tax under a treaty at the time of introduction, because such taxation could violate the realistic expectations of our treaty partners. Congress also believed that the United States should not tax certain pre-existing stapled Puerto Rican corporations, because the possessions corporation rules (sec. 936) offer tax benefits comparable to those of stapling. Congress believed that all stapled entities should have adequate time to remove the requirement that shares trade in tandem, and that adequate time in the case of foreign stapled entities would typically be greater than adequate time in the case of domestic entities.

Explanation of Provision

The Act provides generally that where a foreign and a domestic corporation are stapled entities, the foreign corporation will be treated as domestic. Therefore, the stapled foreign corporation will be subject to U.S. tax on its worldwide income. The characterization of a foreign corporation as a U.S. corporation will be a reorganization that is subject to the rules of section 367. Transfers to a foreign corporation that is treated as a domestic corporation because it is stapled to a domestic corporation will not be taxable (under section 367). Unstapling of a foreign corporation (*e.g.*, by removing a requirement that its shares trade in tandem with those of a U.S. corporation) that had been treated as a domestic corporation under the Act will be a reorganization that is subject to the rules of section 367.

If a foreign corporation and a U.S. corporation were stapled entities on June 30, 1983, the date of introduction of H.R. 3475 (which included a stapled stock provision), the U.S. corporation may elect to be treated as owning all interests in the foreign corporation that constitute stapled interests with respect to stock of the U.S. corporation. To the extent that the stock of both companies is stapled, the U.S. corporation, upon this election, is subject to tax on certain income of the foreign corporation, including its subpart F income, if any. Also, if some of the stock of the foreign corporation (1) is not stapled to stock of the U.S. corporation and (2) belongs to non-U.S. shareholders, then (after an election to treat the foreign corporation as a foreign subsidiary of the U.S. corporation) earnings attributable to that stock or dividends to a foreign shareholder are generally not subject to current U.S. tax. An election to treat a foreign corporation as a foreign subsidiary of a U.S. corporation must be made not later than 180 days after the date of enactment, and in such manner as the Secretary or his delegate shall prescribe. This election will be revocable only with the consent of the Secretary or his delegate.

The stapled stock provision generally overrides treaties. However, the Act does not, in the case of entities stapled on June 30, 1983 and treated as residents of the treaty partner on that date, deny those entities treaty benefits to which they were entitled on that date, so long as the entities remain entitled to those benefits under the applicable treaty. For example, the Act provides that a foreign corporation stapled to a U.S. corporation is taxable as a U.S. corporation. A treaty may provide, for example, that a corporation incorporated under the laws of the treaty partner is not taxable in the United States on industrial or commercial profits unless it has a U.S. permanent establishment (see, e.g., Article III(1) of the U.S.-Netherlands Income Tax Treaty). In such a case, a foreign corporation stapled on June 30, 1983 to a U.S. corporation is entitled to applicable treaty benefits. The Act will not treat it as a U.S. corporation. If treaties are renegotiated to eliminate benefits for stapled companies (a result that would be consistent with Congress' intent), stapled companies will lose current treaty benefits.

Stock in one corporation which constitutes a stapled interest with respect to stock of a second corporation is generally treated as owned by the second corporation for purposes of Code section 1563. The effects of this section 1563 treatment include denial of multiple surtax exemptions and denial of multiple accumulated earnings tax credits. Stapled entities are generally treated as one entity in determining whether any stapled entity is a REIT or RIC. These rules are subject to modification by the Secretary of the Treasury by regulation in cases of undue hardship.

In addition, the Secretary of the Treasury is to prescribe such regulations as will be necessary to prevent avoidance or evasion of Federal income tax through the use of stapled entities. Such regulations are to include, but are not to be limited to, rules providing the extent to which one stapled entity is treated as owning another stapled entity (to the extent of the stapled interest).

Under the standard rules governing consolidated returns, stapled U.S. corporations generally are not eligible to file consolidated returns because there is no common parent corporation. Under the same rules, a foreign corporation that is stapled to a U.S. corporation is not eligible to file a consolidated return with its U.S. sister (whether or not an election to treat the foreign sister as owned by the U.S. company to the extent of the stapling is in effect). The inability to consolidate in this situation will prevent taxpayers from using the stapled stock rules to their advantage (for example, from using losses of a stapled foreign corporation). A contiguous country stapled corporation described in section 1504(d) may be eligible to consolidate under the regular rules, however.

The Act defines the term "entity" to mean any corporation, partnership, trust, association, estate, or other form of carrying on a business or activity. The Act defines the term "stapled entities" to mean any group of two or more entities if more than 50 percent in value of the beneficial ownership in each of the entities consists of stapled interests. Two or more interests are stapled interests if, by reason of form of ownership, restrictions on transfer, or other terms or conditions, in connection with the transfer of one of such interests the other such interests are also transferred or are required to be transferred. However, Congress did not intend to treat stock of a parent corporation as stapled to the stock of a subsidiary corporation.

For example, assume that two U.S. citizens each own 50 percent of a U.S. corporation and a foreign corporation. Under two separate standard death redemption agreements, the corporation agrees to buy, and each shareholder obligates his estate to sell, all of the shares of the first shareholder to die. These shares are not stapled for purposes of the Act, so long as each shareholder may trade shares of the two corporations freely and independently before death.

Again assume that two U.S. citizens each own 50 percent of a U.S. corporation and a foreign corporation. Under two separate standard right of first refusal agreements, neither shareholder may sell or exchange any of the shares of either corporation without allowing the other shareholder (or, alternatively, the corporation) the right to match the price offered for his or her shares. These shares are not stapled for the purpose of the Act, so long as each shareholder may trade shares of the two corporations freely and independently before death.

In addition, for example, a combination of the standard death redemption agreement and the right of first refusal agreements described in the two preceding examples would not cause the shares to be stapled, so long as each shareholder may trade shares of the two corporations freely and independently before death.

The Act's rules do not apply to U.S. corporations stapled to Puerto Rican corporations on June 30, 1983, so long as the Puerto Rican corporation is described in Code section 957(c) (or would be described in that subsection if dividends from section 957(c) corporations were income described in section 957(c)), and if it does not own stock in any corporation that is not described in section 957(c).

To qualify for this treatment, the stapled Puerto Rican corporation must also meet the activity test of section 957 (c)(2).

Effective Date

In general, this provision took effect on July 18, 1984, the date of enactment. However, for interests stapled on or before June 30, 1983, the provision does not apply until January 1, 1985. In addition, the provision does not apply to foreign corporations stapled to U.S. corporations on June 30, 1983, until January 1, 1987. A group of stapled entities that included a REIT on June 30, 1983, is not subject to the rules of the bill if all members of the group were stapled on that date. The Act also contains a special effective date for certain purposes for certain stapled mortgage REITs.

Revenue Effect

The provision is estimated to increase budget receipts by less than $5 million annually.

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16. Insurance of Related Parties by a Controlled Foreign Corporation (sec. 137 of the Act and sec. 954(e) of the Code)[50]

Prior Law

Under present and prior law, the income derived from the insurance of U.S. risks by a controlled foreign corporation is currently taxable to its U.S. shareholders, if the premiums and other consideration that it receives with respect to the U.S. risks exceed five percent of the total premiums and other consideration it receives during the year with respect to all risks (Code sec. 953). Income from the insurance of U.S. risks includes income from insuring property in, or liability arising out of activity in, the United States. This currently taxable income includes investment income associated with the insurance of U.S. risks. Generally, income derived from the insurance of non-U.S. risks was not currently taxable under prior law unless it was taxable as foreign base company services income, discussed below, or foreign oil-related income.

U.S. shareholders of controlled foreign corporations are and were also currently taxable on foreign base company services income for the taxable year. Foreign base company services income means any 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 that are performed for or on behalf of any related person and are performed outside the country under the laws of which the controlled foreign corporation is organized. Under prior law, Treasury regulations indicated that the place of performance would depend on the facts and circumstances of each case. However, in general, under those regulations, the place of performance was where the persons performing the services were physically located when they performed their duties. Thus, under prior law, income earned from insuring risks of related persons in other countries by persons operating physically in a tax haven country arguably was not foreign base company services income.

Reasons for Change

Congress believed that prior-law provisions on related party insurance might allow foreign corporations controlled by U.S. shareholders improperly to shift income to tax havens. As a result, there could be deferral of current tax on that income, or generation of low-taxed foreign-source income available to absorb otherwise unusable foreign tax credits. Congress believed that the essential serv-

[50] For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 136; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 383-384; and H. Rep. No. 98-861 (June 23, 1984), pp. 965-966 (Conference Report).

ice performed under an insurance contract is the indemnity coverage for the risk of loss against which a party is insured. Administrative or investment services performed by a related insurer under the contract generally are incidental to this coverage. In addition, insurance income contains an element of passive investment income, which is typically subject to current U.S. tax as foreign personal holding company income when earned by foreign personal holding companies or controlled foreign corporations. Accordingly, Congress believed that insurance services should be treated as performed in the country in which the risk is located.

In adopting this change, Congress recognized that it was not directly addressing all the problems associated with the use of controlled foreign corporations as captive insurance companies in sophisticated self-insurance arrangements for related persons. Congress did not intend that the provision be construed as affecting any determination as to whether a payment made to a related insurer constitutes self-insurance, the "premium" for which is nondeductible.[51]

Congress extended the application of this provision to 10-percent shareholders (and persons related to them) because it wanted the rule to apply to all U.S. shareholders of controlled foreign corporations. Absent this kind of related party rule, the new provision might apply only to risks of a shareholder that owns 50 percent or more of a controlled foreign corporation. Even in cases of lesser proportionate ownership, however, the shareholders (the insureds) have the ability to control the economics of the insurance arrangement through the use of experience-rated refunds or premium pricing. In this way, they might be able to direct profits (or lower costs) to insureds whose activities caused or whose property suffered little damage.

Explanation of Provision

The Act amends the definition of foreign base company services income to provide specifically that any services performed with respect to any policy of insurance or reinsurance, if the primary insured is a related person, will be treated as having been performed in the country in which the risk of loss against which the related person is insured is located. The income that is subject to tax under this provision includes investment income associated with the insurance of risks of related parties under rules similar to the rules that govern insurance of U.S. risks (sec. 953).

Income from the insurance or reinsurance of non-U.S. risks of a related person that arise outside the country under whose laws the insurer is created or organized will be currently taxable to U.S. shareholders of controlled foreign corporations as foreign base company services income. Congress did not intend double inclusion of income from insurance or reinsurance of U.S. risks that continues to be subject to current taxation (sec. 953), however. That income will continue to be subject to tax under the rules governing insur-

[51] For discussions of the captive insurance issues, see Rev. Rul. 77-316, 1977-2 C.B. 53; and *Carnation Co. v. United States*, 640 F.2d 1010 (9th Cir. 1981), *cert. denied*, 454 U.S. 965 (1981).

ance of U.S. risks; to the extent that it is taxable under those rules, it will not be foreign base company services income.

An example illustrates the operation of the Act. A U.S. corporation owns 10 percent or more of the stock of an insurance company incorporated in a tax haven. The insurance company insures risks of unrelated parties as well as risks of foreign subsidiaries of the U.S. corporation. Under the Act, the foreign insurance company's income from the insurance of risks of those foreign subsidiaries (including associated investment income) is foreign base company services income that is currently taxable to its U.S. shareholders, subject to the rules of subpart F (secs. 951-964). Income that is attributable to the insurance or reinsurance of risks of unrelated parties will ordinarily not be currently taxable to the U.S. shareholders of the controlled foreign corporation, unless its foreign base company income exceeds 70 percent of gross income (or unless those risks are U.S. risks).

This provision will apply only if a valid insurance arrangement is found to exist, and only if the insured related party is the primary insured. For example, if a Bermuda insurance subsidiary of a U.S. corporation validly insures the French plant of the French subsidiary of that U.S. corporation, its income from that insurance contract will be foreign base company services income. By contrast, if a Bermuda insurance subsidiary of a U.S. corporation validly reinsures a risk of an unrelated party that is covered by an insurance contract issued by the U.K. insurance subsidiary of that U.S. corporation, its income from that insurance contract will not be foreign base company services income.

A "related party" whose risks trigger the provision includes 10-percent U.S. shareholders (and persons related to them) of a controlled foreign corporation performing insurance services. Congress made this 10-percent related party test broader than the standard test under the controlled foreign corporation so as to reach all U.S. shareholders of controlled foreign corporations. A technical correction may be necessary to clarify that this special 10-percent related party rule also applies to the general base company services rule of section 954(e)(1) for the limited purpose of the insurance income rule.

Effective Date

The provision applies for taxable years beginning after July 18, 1984, the date of enactment.

Revenue Effect

This provision is estimated to increase budget receipts by $26 million in fiscal year 1984, $44 million in 1985, $46 million in 1986, $49 million in 1987, $51 million in 1988, and $54 million in 1989.

17. Definition of Resident Alien (sec. 138 of the Act and sec. 7701(b) of the Code)[52]

Prior Law

Resident aliens, like U.S. citizens, are subject to U.S. income tax on their worldwide income at the regular graduated rates. Nonresident aliens are subject to U.S. tax only to the extent their income is from U.S. sources or is effectively connected with the conduct of a trade or business within the United States. Certain passive U.S. source income of nonresident aliens is subject to tax at a flat 30-percent rate, while effectively connected income is generally subject to taxation on a net basis at graduated rates. Bilateral income tax treaties may modify the U.S. taxation of a nonresident alien.

Prior to enactment of the Act, the Internal Revenue Code did not define the terms "resident alien" or "nonresident alien." Treasury Regulations generally applied a subjective test and defined the terms on the basis of an alien's intentions with regard to the length and nature of his or her stay (Treas. Reg. sec. 1.871-2). In general, under the regulations, residence depended on whether an alien was "a mere transient or sojourner" in the United States. Living in the United States with no definite intention as to the length and nature of his or her stay made an alien a resident under the regulations. A visa that limited the alien's stay to a definite period made him or her a nonresident absent "exceptional circumstances." An alien could be a resident for tax purposes although neither a resident for immigration purposes nor present in the United States for half the year (*Tongsun Park v. Commissioner,* 79 T.C. 252 (1982)). Under present and prior law, an individual may be a resident of more than one country.

Under prior law (and after enactment of the Act), an alien may be taxable as a resident for part of a year and taxable as a nonresident for the balance of the year.

In certain cases, individuals who earned U.S.-source income could seek to minimize their U.S. tax by claiming that they were taxable on a fiscal year basis rather than on a calendar year basis and thereby allocating their U.S. income into more than one fiscal year if such an allocation was beneficial (e.g., if they had income for only a part of some fiscal year).

Reasons for Change

Congress believed that the tax law should provide a more objective definition of residence for income tax purposes. Congress be-

[52] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 451; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1523-1531; House floor amendment, 130 Cong. Rec. H2738 (April 11, 1984); and H. Rep. No. 98-861 (June 23, 1984), pp. 966-968 (Conference Report).

lieved that prior law did not provide adequate guidance with respect to residence status. Congress understood that an objective definition might allow some aliens who should be taxable as residents to avoid resident status, and would impose resident status on some aliens who are not residents under the current rules. On balance, however, Congress found that the certainty provided by the Act's objective definition outweighed other considerations.

Congress believed that aliens who have entered the United States as permanent residents and who have not officially lost or surrendered the right to permanent U.S. residence should be taxable as U.S. residents. These persons have rights in the United States that are similar to those afforded U.S. citizens (including the right to enter the United States at will); equity demands that they contribute to the cost of running the government on the same basis as citizens.

Congress similarly decided that it was appropriate to treat as residents individuals who spend significant time in the United States. Recognizing that there is no single system that is perfect, Congress believed that a regime that depends on length of stay meets the criteria of objectivity and establishing nexus with the United States and is appropriate. Almost all individuals present in the United States for more than half a year should be taxable as U.S. residents. Moreover, individuals who repeatedly spend significant amounts of time in the United States should have to note their presence with the Internal Revenue Service; if they do not have a closer connection with a foreign country than with the United States and a tax home in that foreign country, they, too, should be taxable as U.S. residents. Congress believed that an average of 122 days of presence over a three year period is a significant amount of time for the purpose of imposing U.S. tax in such circumstances, but that an individual who is present for fewer than 31 days in a year should not be subject to this rule for that year. Congress believed that a residence definition based solely on 183 (or some other number of) days of presence in one year would be inadequate, and intended that individuals in circumstances like those of Tongsun Park (described in 79 T.C. 252), who was here for substantial periods of time over a period of years, be residents under the Act even though their days of presence in a particular year do not equal or exceed 183.

Congress recognized that there are cases in which, because of the reason for the alien's stay in the United States, full U.S. taxation is inappropriate. Accordingly, the Act provides exceptions when aliens come to the United States to teach or to learn rather than for employment, business, economic opportunity, pleasure, personal or family reasons, political stability, or other reasons. Exceptions to the general rules of the provision for some students, teachers, and trainees help the United States to maintain its paramount position in the field of education. Exceptions also seemed appropriate for diplomats and for some persons physically unable to leave the United States.

Congress believed that alien taxpayers who spend brief amounts of time in the United States before moving here or after moving away should generally not be taxable as residents during those brief periods, or during the time between the brief stays and the time the taxpayer moves. Congress also believed that aliens should not be able to switch back and forth between resident status and nonresident status for short periods, and that there should be no gap in resident status when an alien is a resident for part of two consecutive years.

In addition, Congress intended that, under the Act's mechanical tests for residence, long-time U.S. residents not be able to leave the United States for a short period, dispose of assets free of U.S. tax, and then resume U.S. residence. Therefore, Congress extended the rules that tax certain U.S. citizens who renounce U.S. citizenship to long-time residents who leave and return in certain circumstances. Congress extended those rules for this purpose solely because of the clarity of that body of law; Congress believed that those rules should be reexamined in the future (especially to the extent that those rules allow the subsequent disposition of foreign assets held during U.S. citizenship or residence free of U.S. tax).

Congress believed that the Act's definition of residence imposes U.S. tax on aliens only when their relationship with the United States is so close that U.S. inclusion of worldwide income in the tax base is appropriate. (Resident aliens, like U.S. citizens, will continue to credit foreign taxes on foreign income or taxes in lieu thereof.) Congress, therefore, decided that special rules to exempt foreign passive income of some resident aliens were not appropriate. Congress believed that some wealthy aliens spend much time in the United States because of the political stability or economic opportunities our country affords. Congress believed that these aliens should share with other U.S. persons in the financial responsibility for the operations of the Federal Government, even if most of their income is foreign. For reasons of simplicity, too, Congress did not believe that it should create two statutory classes of residents, one taxable on worldwide income, and another taxable on something less.

Congress believed that days of presence of aliens who cannot leave the United States because of a medical condition that arose during their stay here should not count toward the Act's substantial presence test. Recognizing, however, that the Federal Government has contributed to the creation of medical facilities in the United States that are second to none in the world, Congress decided that aliens who come to the United States for medical treatment and stay for extended periods of time should be subject to the Act's regular rules.

Explanation of Provision

Definition of resident alien—general rules

The Act provides a definition of resident alien for U.S. income tax purposes. (The Act does not affect the definition of resident for Federal estate or gift tax purposes.) Aliens who do not meet this definition are nonresident aliens. For income tax purposes, an individual is considered a resident if the individual:

(1) has entered the United States as a lawful permanent U.S. resident (the "green card test"); or

(2) is present in the United States for 31 or more days during the current calendar year and has been present in the United States

for a substantial period of time—183 or more days during a 3-year period weighted toward the present year (the "substantial presence test").[53]

If an individual is present in the United States for fewer than 183 days during the calendar year, and if the individual establishes that he or she has a closer connection with a foreign country than with the United States and has a tax home in that country for the year, the individual will generally not be subject to tax as a resident on account of the substantial presence test. For this purpose, "tax home" means the individual's home for purposes of Code section 162(a)(2) (relating to traveling expenses while away from home) (see Code sec. 911(d)(3)). Thus, maintenance of a U.S. abode will not automatically prevent an individual from establishing a tax home in a foreign country. If an individual is present for as many as 183 days during a calendar year, this closer connections/tax home exception will not be available.

An alien who has an application pending to change his or her status to permanent resident or who has taken other steps to apply for status as a lawful permanent U.S. resident is not eligible for the closer connections/tax home exception. Under current immigration rules, a relative of an alien may apply for the alien to become a lawful permanent U.S. resident. An application by another person is not relevant under the Act. The closer connections/tax home exception is unavailable only when an alien takes an affirmative step to seek permanent resident status. Under current procedures, the filing of a Biographic Information form (now Immigration and Naturalization form G-325A) constitutes an affirmative step to seek permanent resident status when another individual has begun the immigration procedure for the alien.

Days present as an "exempt individual," a term that includes certain foreign government-related individuals, teachers, trainees, and students, do not count as days of U.S. presence for the substantial presence test. In addition, the substantial presence test will not count days of presence of an individual while he or she is physically unable to leave the United States because of a medical condition that arose while he or she was present in the United States. Congress anticipated that few individuals would be physically unable to leave the United States. For example, an individual who is in a serious automobile accident shortly before a planned departure date could be physically unable to leave the United States. Individuals have to establish to the satisfaction of the Secretary of the Treasury that they qualify for this special medical exception.

The Act defines the term "foreign government-related individual" to mean any individual temporarily present in the United States by reason of (1) diplomatic status, or a visa which the Secretary of the Treasury (after consultation with the Secretary of State) determines represents full-time diplomatic or consular status; (2) being a full-time employee of an international organization; or (3) being a member of the immediate family of such a diplomat or

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[53] This substantial presence test will compare 183 days to the sum of (1) the days present during the current calendar year, (2) one-third of the days present during the preceding calendar year, and (3) one-sixth of the days present during the second preceding calendar year. An average of 122 days of presence over three years will trigger the test.

international organization employee. For this purpose, international organizations are those entitled to the benefits of the International Organizations Immunities Act (see sec. 7701(a)(18)).

The term "teacher or trainee" means any individual who is temporarily present in the United States under subparagraph (J) of section 101(15) of the Immigration and Nationality Act[54] (other than as a student), and who substantially complies with the requirements for being so present. An individual will not be able to establish substantial compliance with this or any visa requirement relevant to residence for tax purposes merely by showing that his or her visa had not been revoked. That is, there is to be an independent redetermination, for tax purposes, of whether an alien has substantially complied with visa requirements.

A "student" is any individual who is temporarily present in the United States either under subparagraph (F) of section 101(15) of the Immigration and Nationality Act,[55] or as a student under subparagraph (J) of such section 101(15), and who substantially complies with the requirements for being so present.

An individual cannot be exempt from the substantial presence test as a teacher or trainee if he or she has been exempt as a teacher, trainee, or student for any part of two of the six preceding calendar years. An individual cannot be exempt from the substantial presence test as a student if he or she has been exempt as a teacher, trainee, or student for more than five calendar years, unless that individual establishes to the satisfaction of the Secretary of the Treasury that he or she does not intend to reside permanently in the United States and that he or she has substantially complied with the requirements of the student visa providing for the individual's temporary presence into the United States.

The Act defines "lawful permanent resident" to mean an individual who has the status of having been lawfully accorded the privilege of residing permanently in the United States as an immigrant in accordance with the immigration laws, if such status has not been revoked or administratively or judicially determined to have been abandoned. Therefore, an alien who comes to the United

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[54] Subparagraph (J) of section 101(15) of the Immigration and Nationality Act now applies to "an alien having a residence in a foreign country which he has no intention of abandoning who is a bona fide student, scholar, trainee, teacher, professor, research assistant, specialist, or leader in a field of specialized knowledge or skill, or other person of similar description, who is coming temporarily to the United States as a participant in a program designated by the Secretary of State, for the purpose of teaching, instructing or lecturing, studying, observing, conducting research, consulting, demonstrating special skills, or receiving training and who, if he is coming to the United States to participate in a program under which he will receive graduate medical education or training, also meets the requirements of section 1182 of this title, and the alien spouse and minor children of any such alien if accompanying him or following to join him." The definition for purposes of this tax legislation will change from time to time as the definition in the Immigration and Nationality Act changes.

[55] Subparagraph (F) of section 101(15) of the Immigration and Nationality Act now applies to "(i) an alien having a residence in a foreign country which he has no intention of abandoning, who is a bona fide student qualified to pursue a full course of study and who seeks to enter the United States temporarily and solely for the purpose of pursuing such a course of study at a college, university, seminary, conservatory, academic high school, elementary school, or other academic institution or in a language training program in the United States, particularly designated by him and approved by the Attorney General after consultation with the Secretary of Education, which institution or place of study shall have agreed to report to the Attorney General the termination of attendance of each nonimmigrant student, and if any such institution of learning or place of study fails to make reports promptly the approval shall be withdrawn and (ii) the alien spouse and minor children of any such alien if accompanying him or following to join him." The definition for purposes of this tax legislation will change from time to time as the definition in the Immigration and Nationality Act changes.

States so infrequently that, on scrutiny, he or she is no longer legally entitled to permanent resident status, but who has not officially lost or abandoned that status, will be a resident for tax purposes. The purpose for this requirement of revocation or determination is to prevent aliens from attempting to retain an apparent right to enter or remain in the United States while attempting to avoid the tax responsibility that accompanies that right.

Presence during a day is generally presence at any time during the day. If an alien is present in the United States in transit for a period of 24 hours or less (for example, in a U.S. airport en route from Canada to South America), however, he or she will not count any day during such transit as a day of U.S. presence for the purpose of the substantial presence test. Regular commuters to employment or self employment in the United States from a place of residence in Canada or Mexico are not treated as present in the United States on days when they so commute.

The Secretary of the Treasury is authorized to require aliens who claim exemption from the substantial presence test (whether under the closer connection/tax home exception or any other exception) to file statements explaining the basis for their exemption. It is within the discretion of the Secretary to impose such requirements by regulation.

A taxpayer who becomes a U.S. resident and who has not established a taxable year for any prior period in the United States is taxed on a calendar year basis. A taxpayer who establishes a fiscal year determines residence on a calendar year basis, and is subject to tax as a resident for any portion of his or her fiscal year within a calendar year of residence.

The definition of resident alien contained in the Act could conflict with existing treaty obligations of the United States. That is, the definition in the bill could cause an alien to be a U.S. resident, while "tie-breaker" rules in an income tax treaty could indicate that the alien is a resident of the treaty partner (see, e.g., Article 4 of the U.S. Model Income Tax Treaty, and Article 4(2) of the U.S.-United Kingdom Income Tax Treaty). Congress did not intend to override treaty obligations of the United States on this point; therefore, in such a case, the individual will be entitled to any benefits that the treaty gives him or her. For example, an alien who is a resident of the United States under the new statutory definition but who is a resident of a treaty partner of the United States (and not a resident of the United States) under a U.S. income tax treaty is eligible for the benefits that the treaty extends to residents of the treaty partner. However, notwithstanding the treatment of the alien as a resident of the other country for treaty purposes, the Act treats the alien as a U.S. resident for purposes of the internal tax laws of the United States. For example, if the alien owns more than 50 percent of the voting power of a foreign corporation, the foreign corporation will be a controlled foreign corporation (sec. 957). The U.S. income tax treaty with the alien's country may prevent U.S. taxation of the alien's share of the undistributed earnings of the controlled foreign corporation. However, the United States will apply its regular rules in determining the U.S. tax of a U.S. citizen who is a minority 10-percent shareholder in that controlled foreign corporation.

The Act allows the Secretary to prescribe regulations to carry out the purpose of this provision of the Act. In particular, Congress understood that regulations may be necessary to coordinate U.S. taxing jurisdiction with the taxing jurisdictions of U.S. possessions the basis of whose tax law is the Internal Revenue Code. Congress did not intend, for example, that the Act make an alien present for 183 days in the United States and for 183 days in the U.S. Virgin Islands a resident both of the United States and the U.S. Virgin Islands for tax purposes for that year.

Congress, in changing the definition of U.S. residence for U.S. tax purposes, did not change the definition of foreign residence for U.S. tax purposes. Therefore, the term "bona fide resident of a foreign country" for the purposes of the tax benefits for foreign earned income retains its prior meaning (sec. 911(d)(1)(A)), and a U.S. citizen who is present in a foreign country for 183 days during a calendar year is not automatically a "bona fide resident" of that country. Similarly, the Act has no bearing on the residence of a U.S. citizen for the purpose of any U.S. tax treaty (such as a treaty that benefits residents, rather than citizens, of the United States).

Congress did not intend that the definitions of resident alien and nonresident alien in the Act affect the determination whether a trust or an estate is a U.S. or a foreign trust or estate (secs. 7701(a)(30) and (31)) except insofar as that determination itself turns on the residence or nonresidence of particular alien individuals.

Time of residence

Beginning of residence

An alien who was a U.S. resident during the preceding calendar year and who is a U.S. resident for the current year continues to be taxable as a resident at the beginning of the current year. That is, residence for tax purposes does not lapse, but continues throughout both years. For example, an alien who is present in the United States from January 1 to August 1 in 1985 and from June 1 to December 31 in 1986 is a U.S. resident for all of 1985 and 1986. Similarly, an alien who is present in the United States from January 1 to August 1 in 1985, who first arrives in the United States in 1986 on December 1, and who becomes a lawful permanent U.S. resident on December 1, 1986, is a U.S. resident for all of 1985 and 1986.

An alien who was not a U.S. resident during the preceding calendar year but who is a U.S. resident for the current year begins to be a resident for tax purposes on his or her residency starting date. The residency starting date, under rules discussed below, may not be the beginning of the current year.

An alien who first becomes a lawful permanent resident (and thus first satisfies the "green card" test) during the year ordinarily begins to be a U.S. resident for tax purposes on the first day he or she was present in the United States while a lawful permanent resident of the United States. If the alien was a U.S. resident during the preceding year, however, residence for tax purposes will not lapse, but will continue throughout both years. If an individual was a lawful permanent U.S. resident during all of 1984, he or she will generally be a U.S. resident during all of 1985, whether or not he or she is present in the United States during 1985.

An alien who was not a resident during the preceding year but who satisfies the substantial presence test for the current year ordinarily begins to be a U.S. resident for tax purposes on the first day during the year when he or she is physically present in the United States. The Act creates an exception, however, for certain nominal presence during the year. (This nominal presence exception does not postpone the beginning of residence under the "green card" test.) If an alien meets only the substantial presence test for the year, but spends time here when he or she has a closer connection to a foreign country than to the United States, the alien may not begin to be a resident for tax purposes during a period of ten or fewer days during that time. The purpose of this nominal presence exception is to allow brief presence in the United States (for example, for business or for house-hunting) before moving to the United States without triggering residence status.

For example, an alien (who has never before been a U.S. resident for tax purposes) who lives in Spain until May 15, who moves to the United States on May 15 and who remains in the United States through the end of the year will begin to be a U.S. resident for tax purposes on May 15. Similarly, an alien (who has never before been a U.S. resident for tax purposes) who comes to a business meeting in the United States on February 2 through 8, who otherwise lives in Spain until May 15, who moves to the United States on May 15 and who remains in the United States through the end of the year will begin to be a U.S. resident for tax purposes on May 15, if he or she can establish a closer connection to a foreign country (presumably Spain in this example) than to the United States for the period of U.S. presence in February. However, Congress did not provide that an alien could end (or begin) a closer connection with a foreign country while physically present in the United States. For example, an alien continuously present in the United States from May 1 to December 31 only, during a year, is not eligible for this nominal presence rule for any part of the first ten days of May.

If an alien was not a resident during the preceding year but satisfies the substantial presence test as well as the "green card" test for the current year, his or her residence for tax purposes begins on the earlier of (1) the first day he or she was present in the United States while a lawful permanent resident of the United States or (2) his or her residency starting date under the substantial presence test. For example, if such an alien (1) is present in the United States from January 1 to May 1 and from October 1 to December 31 and (2) first meets the "green card" test on November 1, his or her residence for tax purposes begins on January 1.

Termination of residence

An alien who is a U.S. resident during the current year and who is also a U.S. resident during the following year is taxable as a resident through the end of the current year. That is, residence for tax purposes does not lapse, but continues throughout both years. An alien who is a U.S. resident during the current year but who is not a U.S. resident for the following year may or may not be taxable as a U.S. resident through the end of the current year.

An alien who ceases to be a lawful permanent resident (and thus ceases to satisfy the "green card" test) during the year typically ceases to be a U.S. resident for tax purposes on the first day he or she is no longer a lawful permanent resident of the United States. If the alien is a U.S. resident (under either the "green card" test or the substantial presence test) during the following year, however, residence for tax purposes does not lapse, but continues throughout both years.

An alien who is not a resident during the following year but who satisfies the substantial presence test for the current year will ordinarily cease to be a U.S. resident for tax purposes on the last day during the year when he or she is physically present in the United States. The Act creates an exception, however, for certain nominal presence during the year. If an alien meets the substantial presence test for the year, but spends ten or fewer days in the United States at a time when he or she has a closer connection to a foreign country than to the United States, the alien is not a resident for tax purposes during that period of ten or fewer days. The purpose of this nominal presence exception is to allow brief presence in the United States (for example, for business or for disposing of a U.S. residence) without extending residence status. Again, this nominal presence exception does not apply to aliens meeting the "green card" test.

For example, an alien (who is not during the following year a U.S. resident for tax purposes) who lives in the United States until September 15, who moves to Brazil on September 15, and who does not return to the United States during the year will cease to be a U.S. resident for tax purposes on September 15. Similarly, an alien (who is not during the following year a U.S. resident for tax purposes) who lives in the United States until September 15, who moves to Brazil on September 15, and who comes to a business meeting in the United States on November 2 through 8 will cease to be a U.S. resident for tax purposes on September 15, if he or she can establish a closer connection to a foreign country (presumably Brazil, in this example) than to the United States for the period of U.S. presence in November.

If an alien is not a resident during the following year but satisfies the substantial presence test as well as the "green card" test for the current year, his or her residence for tax purposes will end on the later of (1) the first day he or she is no longer a lawful permanent resident of the United States or (2) the last day he or she was a resident under the substantial presence test. For example, if an alien who is not a resident during the following year (1) is present in the United States from January 1 to August 1 and from October 1 to October 5, (2) can establish a closer connection to a foreign country than to the United States for the period of U.S. presence in October, and (3) suffers revocation of his or her "green card" on November 1, his or her residence for tax purposes ends on November 1. If "green card" revocation occurred on September 15 in this example, however, residence would end on September 15. If "green card" revocation occurred on October 3, residence would end on October 3. If "green card" revocation occurred on March 5, residence would end on August 1.

Break in residence status

If an individual is a resident of the United States for three consecutive years under the new statutory definition and is a resident of the United States during one of the next three years, then he or she will be subject to U.S. tax for all intermediate years on the same items of income that would be taxed to a U.S. citizen who renounced U.S. citizenship for the principal purpose of avoiding U.S. tax (sec. 877). This rule will apply regardless of the subjective intent of the alien.

Effective Date

These provisions apply to taxable years beginning after December 31, 1984. However, pre-1985 presence of an alien who was not a resident (under prior law) at the close of 1984 will not count in the substantial presence test; pre-1984 presence of an alien will count only if that individual was a resident (under prior law) at the end of both 1983 and 1984.

A separate effective date rule applies to "green card" holders. Residence for tax purposes of an individual who is a lawful permanent resident on January 1, 1985, will begin on that date if the individual meets either of two conditions: (1) he or she was a lawful permanent resident during all of 1984 (whether or not he or she was present in the United States during 1984) or (2) he or she was present here at any time in 1984 while a lawful permanent U.S. resident. This effective date provision operates by making any delay in the residency starting date (under sec. 7701(b)(2)(A)) inapplicable for 1985 to these individuals and by deeming these individuals to have been residents of the United States in 1984 for the purpose of this effective date rule only. Congress understood that an alien must be present in the United States at least once a year to maintain the status of lawful permanent resident. The purpose of this effective date rule is to delay tax resident status for only new green cardholders for a short time. Congress understood further that an alien may acquire lawful permanent resident status for immigration purposes before U.S. presence. Congress sought to impose tax resident status on all lawful permanent residents once they arrive in the United States. The Act does not affect the determination of residence, even for green card holders, for taxable years beginning before January 1, 1985.

The rules making students and teachers residents after stated periods of residence in those capacities apply only when those stated periods occur after 1984. For example, an alien present as a student during the calendar years 1982-1987 will not be subject to the Act's five-year rule for students in 1987. Conversely, an alien present as a student during the calendar years 1985-1990 will be subject to the Act's five-year rule for students in 1990.

Revenue Effect

The provision is estimated to increase budget receipts by $5 million in 1984 and $10 million annually for 1985–1989.

18. Treatment of Community Property Income of Nonresident Aliens (sec. 139 of the Act and sec. 879 of the Code)[56]

Prior Law

Nonresident aliens are subject to U.S. tax at the regular graduated rates on income that is effectively connected with the conduct of a trade or business within the United States. Under present and prior law, if one spouse is a U.S. citizen or resident while the other is a nonresident alien, the earned income of each spouse, the trade or business income of each spouse, the partnership share of trade or business income of each spouse, or the community income from the separate property of each spouse is generally treated as the income of that spouse (sec. 879). Therefore, if that income is effectively connected income, the couple generally may not split that income for U.S. tax purposes even though the legal right to the income may be split between the spouses under applicable community property laws. A couple of one of whom is a nonresident alien is eligible to make a single return jointly of income taxes if the couple agrees that the nonresident alien's worldwide income will be subject to U.S. tax (sec. 6013). However, under prior law, if *both* spouses were nonresident aliens from a community property country, they might have been able to split the effectively connected income of either spouse to reduce their U.S. tax liability. For example, if a married nonresident alien worked in the United States, while his or her nonresident alien spouse remained outside the United States, the amount of U.S. tax due on the worker's U.S. earnings depended on the local law of the country of the couple's residence. If the couple resided in a country whose community property law treated each spouse as the owner of half the worker's income, each spouse would have paid U.S. tax on half the worker's U.S. earnings.

Reasons for Change

A graduated income tax like that of the United States may impose less tax on a given amount of income if the income belongs to more than one person. Income-splitting reduces tax when the taxpayers are in different tax brackets absent splitting. Therefore, when married taxpayers split their income, they may reduce their combined tax liability. Congress has allowed married couples, in effect, to split income for tax purposes in cases where all of the income of the couple is subject to U.S. tax. Congress did not believe it proper to continue to allow income splitting in any cases where

[56] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 452; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1532-1533; H. Rep. No. 98-861 (June 23, 1984), pp. 968 (Conference Report); and H. Con. Res. 328, 130 *Cong. Rec.* S8945 (June 29, 1984), H7526 (June 29, 1984).

the couple is not taxable on all its worldwide income. Therefore, Congress removed the ability of certain nonresident aliens to split US. income for U.S. tax purposes. At the same time, Congress decided not to extend to couples composed of nonresident aliens the privilege of making a single return jointly of income taxes on the worldwide income of both. Congress arrived at this decision because of concerns about the administration of a tax with so broad a base on individuals with so little U.S. nexus, and because of concerns that that privilege could afford some such individuals undue U.S. tax planning opportunities.

Explanation of Provision

The Act provides that, for U.S. income tax purposes, a married couple of which both spouses are nonresident alien individuals will treat the earned income, the trade or business income, the partnership share of trade or business income and the community income from the separate property of each spouse as the income of that spouse, regardless of any community property laws. Each spouse will be subject to U.S. tax at the regular graduated rates applicable to married persons filing separate returns when such income is effectively connected with the conduct of a U.S. trade or business.

Effective Date

This provision applies to taxable years beginning after December 31, 1984.

Revenue Effect

This provision is estimated to increase budget receipts by $2 million in 1984 and $5 million annually for 1985-1989.

K. Compliance Provisions

1. Provisions Relating to Tax Shelters

a. Registration of tax shelters (sec. 141 of the Act and new secs. 6111 and 6707 of the Code)[1]

Prior Law

There was no requirement under prior law that tax shelters register with the Internal Revenue Service. As a result, the Internal Revenue Service lacked complete and systematic information on which to base its decisions about which shelters should be audited.

The requirement that securities be registered with either the Securities and Exchange Commission (SEC) or a State agency, or both, applies to many tax shelters. It is unlawful to make use of any means or instruments of transportation or communication in interstate commerce or the mails in connection with the sale of any security unless that security is registered as provided in 15 U.S.C. sec. 77f. Classes of securities exempt from this requirement are listed in 15 U.S.C. sec. 77c and transactions exempt from this requirement are listed in 15 U.S.C. sec 77d.

Any security that is part of an issue offered and sold only to residents of a single State by an issuer within that State is also exempt from registration under 15 U.S.C. sec. 77c(a)(11). A number of States also require registration of securities.

Reasons for Change

Congress was concerned that promoters of and investors in syndicated investments and tax shelters were profiting from the inability of the Treasury to examine effectively every return. These promoters knew that even if a tax scheme they marketed was clearly faulty, some investors' incorrect returns would escape detection and many others would enjoy a substantial deferral of tax while the Treasury searched for their returns and coordinated its handling of similar cases. Also, Congress believed that registration will provide the Internal Revenue Service with basic information that will be useful in detecting trends in tax shelter promotions at an early date. The requirement that taxpayers include the registration number on their tax returns will enable the Internal Revenue Service to process these returns more efficiently and will enable the Internal Revenue Service to treat similarly situated taxpayers in the same manner.

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[1] For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 146; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 425-428; and H. Rep. No. 98-861 (June 23, 1984), pp. 977-981 (Conference Report).

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Congress expected that having the registration information available for use prior to the time that any returns are filed by investors will enable the Internal Revenue Service to make better informed judgments concerning the desirability of auditing returns reflecting an investment, and that this will reduce inappropriate audits. The mere fact that a registration form for a particular investment is filed with the Internal Revenue Service should not, however, in and of itself increase the likelihood that returns reflecting that investment will be audited.

Explanation of Provision

Overview

The person having principal responsibility for organizing a tax shelter must register that tax shelter with the Internal Revenue Service. A tax shelter is defined as any investment with respect to which a person could reasonably infer from the representations made that, as of the close of any of the first 5 years, the ratio of deductions and 200 percent of credits to cash invested is greater than 2 to 1. A tax shelter must also be subject to Federal or State securities law requirements or must meet specified size requirements. The Internal Revenue Service will give the person registering the investment a tax shelter identification number, which must be given to each investor. The investor must include the number on his or her tax return.

Time and manner of registration

The Act provides that anyone who organizes a tax shelter must register the shelter by completing a registration form prescribed by the Internal Revenue Service, on which information must be supplied that briefly describes the investment and identifies the promoter. A tax shelter is considered registered when the registration form is mailed to or otherwise filed with the Internal Revenue Service in the manner required. This must be done not later than the day on which the first offering for sale of interests in the tax shelter occurs. Requiring registration by this date will enable State securities regulators to prohibit offerings of unregistered shelters in their States.

A tax shelter is required to be registered by the person having principal responsibility for organizing the tax shelter. In many cases, the tax shelter organizer will be the tax shelter promoter. The tax shelter organizer need not, however, be the promoter or general partner. For example, if a person structures or develops a series of related schemes from which he or a related party will benefit through service contracts or asset purchases, that person will be treated as the tax shelter organizer, even though each of the different arrangements is managed or promoted by a different individual.

If the person principally responsible for organizing the tax shelter fails to register the shelter as required, then any person who participates in the organization of the shelter must register the shelter. A person who is secondarily liable for registering the shelter must register it not later than the day on which the first offering for sale of any interest in the shelter is made. In the event that persons who are principally and secondarily liable for registering a shelter fail to register the shelter, any person participating in the management or sale of the investment must register the shelter. Registration by the manager or seller does not relieve the organizer or promoter of liability for the penalties for failure to register.

Ordinarily, the rendition of professional advice by an unrelated attorney or accountant would not constitute the organization of a tax shelter. However, if, for example, the attorney's or accountant's fee is based, either in part or in whole, upon the number or value of units sold, the Internal Revenue Service might reasonably conclude that the attorney or accountant is an organizer, promoter, or seller of a tax shelter, since he participates in the entrepreneurial risk borne by other promoters.

Congress anticipated that the Internal Revenue Service would provide for registration using a form that will provide, for example: (1) identifying information relating to the tax shelter and the organizer, (2) the type of business organization of the shelter and its accounting method, (3) information concerning the business activities and principal asset of the shelter, (4) the form and source of financing, (5) information regarding Federal or State securities registration, (6) the tax shelter ratio, (7) the number and cost of investment units available, (8) the acquisition cost per unit, and (9) the date the first unit may be offered for sale.[2] Congress anticipated that the Secretary would require this form to be filed in machine-readable format under his present law authority to require that returns be filed on magnetic media or in another machine-readable format. Registration should become a routine task during the organization of tax shelters.

Definition of tax shelter

A tax shelter is defined as any investment (including service contracts and leasing contracts) with respect to which a person could reasonably infer from the representations made or to be made in connection with any offer for sale of any interest that, as of the close of any of the first 5 years, the ratio with respect to any investor of (A) the aggregate of deductions and 200 percent of the credits potentially allowable to (B) the aggregate of the cash invested and the adjusted basis of other property contributed by the investor (reduced by any liability to which that property is subject) is greater than 2 to 1. Year, for purposes of these computations, is defined as the taxable year of the tax shelter, or, if the tax shelter has no taxable year, then a calendar year.

In addition, for registration to be required, a tax shelter must be (1) required to register under a Federal or State law regulating the offering or sale of securities, (2) offered for sale pursuant to an exemption from registration requiring the filing of a notice with a Federal or State agency regulating securities, or (3) a substantial investment.

Congress initially considered computing the tax shelter ratio by taking income into account, but rejected this concept as a general rule because registration must be done on a prospective basis,

[2] On August 13, 1984, the Internal Revenue Service released Form 8264, Application for Registration of a Tax Shelter (see I.R.S. News Release IR-84-88).

which means that only projected income can be taken into account. Congress was concerned that some promoters might exaggerate projections of income to avoid having to register the shelter. Congress also intended, however, that the Internal Revenue Service utilize its regulatory authority to exclude from registration investments with respect to which taxes on projected income exceed any reduction in tax attributable to the investment, so long as the danger of exaggerated projections of income is not present.[3]

Only credits that are potentially allowable under subtitle A of the Code are required to be included as credits in the tax shelter ratio. Consequently, state tax credits would not be considered credits for this purpose.

For purposes of computing this tax shelter ratio, amounts borrowed from a participant in the organization, sale, or management of the shelter or a person related to a participant are not considered to be cash invested. The definition of a related person for purposes of this provision is the same as the definition that is used in ACRS (sec. 168(e)(4)). Thus, for example, family members, related corporations, related trusts, and related partnerships are all considered to be related persons. In addition, an amount held in cash equivalent or marketable securities is not considered to be cash invested. The Secretary is given authority to prescribe regulations that include or exclude amounts in the aggregate of cash invested and the adjusted basis of contributed property.

An investment is a substantial investment if the aggregate nominal amount that may be offered for sale to all investors exceeds $250,000 and 5 or more investors are expected. The aggregate nominal amount offered for sale includes all cash, all contributions of property, and all loans, whether recourse or nonrecourse. The aggregate nominal amount offered for sale is not the same as the investment amount used to compute the tax shelter ratio. The investment does not have to be publicly offered, such as through newspaper advertisements, in order to be considered a substantial investment.

For purposes of this definition, similar investments organized by the same person are aggregated. For example, assume a sponsor of tax shelters develops generally similar investment plans or arrangements involving 8 different partnerships, each investing in a different item (such as a separate master recording or film), each with a different general partner, and each with 3 limited partners. If each partner invests $1,000 cash and $10,000 in nonrecourse obligations, there will be 32 investors (1 general partner plus 3 limited partners times 8 partnerships) and an aggregate investment of $352,000 (32 partners times $11,000). Thus, each partnership will constitute part of a substantial investment. If, in this example, representations are made that $1,000 in tax credits and $3,000 in deductions are available to each limited partner in the first year, the sponsor will be required to register all of the partnerships.

[3] The temporary regulations recently issued by the Treasury that modify the registration requirements for projected income investments that are not investments in certain types of property reflect this intent of Congress (49 FR 43640, October 31, 1984).

Congress intended that, consistent with the changes made in the partnership provisions, tiered pass-through entities not be used as a means of circumventing these registration requirements.

None of the terms used in this provision is intended necessarily to be limited to the meaning ascribed to it under Federal or State laws regulating securities. For example, the term "offered" as used in this provision refers to any representation, whether oral or written, relating to the tax shelter; it includes any advertisement relating to the tax shelter. An act may constitute an offer for sale under this provision which does not constitute an offer under Federal or State securities laws. Similarly, the term "filing of a notice" refers to providing any document to any Federal or State agency regulating securities in connection with offerings or sales of investments even if providing the document is not required by the agency.

Regulatory authority

The Secretary is given authority to issue regulations to provide exemptions from registration. Congress expected and intended that this authority would be exercised to exempt from registration those investments, and only those investments, with respect to which registration would not be useful to the Internal Revenue Service. The Internal Revenue Service could provide these exclusions in several ways. It could alter the investment base, either in general or with respect to specific types of investments. It also could describe specific investments, or investments in specific types of property, that would be excluded from registration.

The Secretary is also given authority to provide necessary and appropriate rules to carry out the purposes of this provision with respect to foreign tax shelters. Congress was concerned about the evident growth in foreign tax shelters. It therefore gave the Secretary broad authority to require registration of investments that involve a foreign situs, even if the same investment would not be required to register if it involved no foreign situs.

The Secretary may require that, when a promoter discloses to potential investors the fact of registration with the Internal Revenue Service, the promoter and seller must also indicate that this registration does not imply approval of the investment or of the claimed tax benefits by the Internal Revenue Service.

Use of numbers

The Internal Revenue Service will provide a tax shelter identification number to the person who registers the investment. Anyone who sells (or otherwise transfers) an interest in a tax shelter must furnish the tax shelter identification number to each investor in the investment. The person who registers the shelter must supply the tax shelter identification number to anyone, such as sellers of the investment, who is required to give the tax shelter identification number to someone else, such as the investor.

Any person who claims any deduction, credit, or other tax benefit by reason of a tax shelter that is required to register must include the tax shelter identification number on the return claiming the benefit in the manner the Secretary requires. This could be done, for example, by requiring that the number be included next to the location on the return where the benefit was claimed, or by requiring that it be included on a separate form to be attached to the return. It can also be required to be attached to an application for a tentative refund ("quickie refund").

Penalties

The penalty for failure to register is the greater of $500 or 1 percent of the aggregate amount invested in the shelter, up to a maximum of $10,000 with respect to any one shelter. The maximum does not apply in cases of intentional disregard of the registration requirement. No penalty is imposed if the failure to register is due to reasonable cause. Reasonable cause for failure to register not later than the day on which the first offering for sale of interests in the shelter occurs would generally exist with respect to a person who participates in the sale of an investment and who is required to register the investment under new section 6111(d)(1)(C) if this person registered the shelter as soon as practicable after discovering that the investment had not been registered under new section 6111(d)(1)(A) or (B). Persons (such as promoters) required to furnish an identification number and who fail to do so are subject to a penalty of $100. The penalty for each failure by the investor to furnish the number on its tax return is $50, unless the failure is due to reasonable cause.

Effective Date

Registration is required for any tax shelter with respect to which any interest is first sold to an investor on or after September 1, 1984.[4] Only the aggregate of interests which may be offered for sale on or after September 1, 1984, must be considered in determining whether a substantial investment would be required to register. This will occur when there are expected to be 5 or more investors on or after September 1, 1984, and the aggregate amount which may be offered for sale on or after September 1, 1984, exceeds $250,000. If a shelter is required to be registered, the tax shelter identification number must be furnished to all investors, regardless of whether they invested before, on, or after September 1, 1984. With respect to interests sold before September 1, 1984, however, the number must be furnished by December 31, 1984.

b. Promoter lists (sec. 142 of the Act and new secs. 6112 and 6708 of the Code) [5]

Prior Law

There was no specific requirement under prior law that promoters and sellers of tax shelters maintain lists of investors available

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[4] Generally, a tax shelter must be registered with the Internal Revenue Service not later than the day on which the first offering for sale of interests in the tax shelter occurs. Treasury provided that failure to register a tax shelter by November 5, 1984, would not be subject to the penalty for failure to register because reasonable cause for failure to register before that date existed with respect to all tax shelters (see Treas. Reg. sec. 301.6707-1T, question and answer #5 (49 F.R. 32726, August 15, 1984) (Extension to September 30, 1984); I.R.S. Release No. 84-102 (September 28, 1984) (Extention to October 31, 1984); I.R.S. Release No. 84-112 (October 26, 1984) (Extension to November 5, 1984)).

[5] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 151; H. Rep. No. 98-432, Pt.

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for inspection by the Internal Revenue Service. Thus, when the Internal Revenue Service identified an abusive tax shelter, it would be able to identify taxpayers who invested in the shelter only through enforcement of summonses or not at all.

In other contexts, prior and present law provides means for the Internal Revenue Service to pursue taxpayers who were led into a questionable tax position through the representations of a promoter or other third party. For example, the partnership audit provisions of TEFRA enable the Internal Revenue Service to examine partnership issues in a single proceeding and to make appropriate adjustments in the individual partners' returns automatically. Elsewhere, the Code requires that income tax return preparers retain for 3 years either the returns prepared by them or a list of taxpayers for whom returns were prepared. This provision enables the Service to examine, for example, the returns prepared by a particular person if it finds a pattern of improper return preparation by that preparer.

Reasons for Change

Congress was concerned that promoters of and investors in syndicated investments and tax shelters were profiting from the inability of the Internal Revenue Service to examine effectively every return. These promoters knew that even if a tax scheme they marketed was clearly faulty, some investors' incorrect returns would escape detection and many others would enjoy a substantial deferral of tax while the Internal Revenue Service searched for their returns and coordinated its handling of similar cases.

The new requirement that promoters keep lists of customers and investments will enable the Internal Revenue Service to identify quickly all of the participants in related tax-shelter investments. As a result, taxpayers claiming improper treatment will not escape detection and investors in similar schemes will receive more uniform treatment.

Explanation of Provision

Under the Act, any person who organizes any potentially abusive tax shelter or who sells any interest in such a shelter must maintain lists of purchasers. A potentially abusive tax shelter is any tax shelter required to register with the Internal Revenue Service under the provisions of section 6111 (which is described immediately preceding this description). It is also an entity, investment plan or arrangement, or any other plan or arrangement that is of a type that has a potential for tax avoidance or evasion and that is described in regulations to be issued by the Secretary. In designating these other arrangements, the Secretary may, for example, specifically identify types of investments, or he may provide that any investment falling within a modified form of the definition of tax shelter for registration purposes is subject to the listing requirement. The Secretary may exercise this authority by requiring, for

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2 (March 5, 1984), pp. 1351-1352; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 145; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 425-428; and H. Rep. No. 98-861 (June 23, 1984), pp. 981-983 (Conference Report).

example, that any plan or arrangement that would be subject to tax shelter registration if the tax shelter ratio were 1 to 1 rather than 2 to 1 must maintain lists of investors.

In particular, any promoter or seller of a tax shelter for which registration is required must maintain lists of the persons purchasing an interest in the tax shelter and must make these lists available to the Internal Revenue Service when requested. The Internal Revenue Service is not required to obtain a summons in order to gain access to these lists. Each list must include the name, address, and taxpayer identification number of each purchaser, as well as any other information that the Secretary may, by regulations, require. The lists must generally be maintained for 7 years.

If a potentially abusive tax shelter is sold in a series of transactions, a list of customers must be maintained at each level in the series. For example, if a tax shelter organizer develops several types of tax shelters which he sells to several promoters, the organizer must maintain lists identifying the promoters. When the promoters sell the tax shelters to investors, the promoters must similarly maintain lists identifying the investors. If an investor sells his interest to another investor, the selling investor must maintain information identifying the purchasing investor. The Secretary may provide that the selling investor may obtain less identifying information from the buying investor than would otherwise be required or retain that information for a shorter period of time than the 7 years, so long as those rules also prevent abuse by taxpayers attempting to avoid the purpose of this provision, which is to facilitate clear identification of all purchasers of potentially abusive tax shelters.

The Secretary is given regulatory authority to provide that, in cases in which two or more persons are required to maintain an identical list, or identical portions of a list, only one person is required to maintain the list.

The penalty for any failure to meet any of the requirements of this provision is $50 for each person with respect to whom there is a failure, up to a maximum of $50,000 in any calendar year. The penalty is not to be imposed where the failure is due to reasonable cause and not willful neglect. This penalty is in addition to any other penalty provided by law.

No inference should be drawn from the Act that there is any restriction placed on the authority of the Secretary under present law to require that books and records be kept, to prescribe the form in which those books and records must be kept, or to obtain customer lists through the use of administrative summonses.

Effective Date

The provision became effective with respect to any interest sold for the first time to an investor on or after September 1, 1984. Thus, if an investor sells an interest he bought before September 1, 1984, to another investor on or after September 1, 1984, the seller is not required to maintain lists. If a promoter sells some interests to investors before September 1, 1984, and other interests on or after that date, the promoter must maintain lists identifying investors in all sales occurring on or after September 1, 1984. The sale of an entity by an organizer to another organizer or promoter is not considered to be a first sale. Thus, if an organizer sells an entity before September 1, 1984, to another organizer or promoter ("the buyer"), and the buyer sells interests in the entity on or after September 1, 1984, the buyer must maintain lists of customers.

c. Increase in penalty for promoting abusive tax shelters and injunction against aiding or abetting the understatement of tax liability (sec. 143 of the Act and secs. 6700 and 7408 of the Code) [6]

Prior Law

Under prior and present law, any person who organizes, assists in the organization of, or participates in the sale of any interest in a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement and who makes or furnishes (in connection with such organization or sale), (1) a statement with respect to the allowability of any tax benefit by reason of participating in the entity, plan or arrangement which the person knows or has reason to know is false or fraudulent as to any material matter, or (2) a gross valuation overstatement with respect to any matter material to the entity, plan or arrangement (whether or not the accuracy of the statement of valuation is disclaimed) is subject to a civil penalty. Thus, persons subject to the penalty may include not only the promoter of a tax shelter partnership but also any other person who organizes or participates in the sale of a plan or arrangement with respect to which there are material misrepresentations or valuation errors affecting the tax benefits to be derived from participation in the arrangement.

Under prior law, the penalty for promoting an abusive tax shelter was equal to the greater of $1,000 or 10 percent of the gross income derived, or to be derived, from the activity. Under prior and present law, there need not be reliance on the information by the purchasing taxpayer or actual underreporting of tax.

Under prior and present law, the Secretary is given authority to waive all or part of any penalty resulting from a gross valuation overstatement, upon a showing that there was a reasonable basis for the valuation and the valuation was made in good faith.

Section 7408 authorizes an action to enjoin any person from engaging in conduct subject to this penalty.

Reasons for Change

The attention of Congress was drawn to evidence that the 10-percent penalty enacted in TEFRA was inadequate in amount since many promoters of abusive tax shelters operate on a large margin. Congress also believed that abusive activities of promoters conducted after the organization or sale of the shelter, such as providing false partnership returns, should also be subject to injunction.

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[6] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 154; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1357-1358; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 149; S. Prt. 98-169, Vol. 1 (April 2, 1984), pp. 434-435; and H. Rep. No. 98-861 (June 23, 1984), pp. 983-984 (Conference Report).

Explanation of Provision

The Act increases the penalty from 10 percent to 20 percent of the income derived or to be derived from the organization or sale of the abusive tax shelter. The $1,000 minimum remains unchanged.

The Act also provides that activities subject to the penalty for aiding and abetting the understatement of tax liability under section 6701 are subject to injunction under section 7408. Consequently, statements incidental to the operation of an abusive tax shelter, in addition to statements made in the organization or sale of an abusive tax shelter, are subject to injunction. Thus, injunctive relief can be granted with respect to activities subject to penalty under either section 6700 or section 6701, or both, as appropriate.

No inference should be drawn that the general injunctive power of the district courts under section 7402(a) is, in any way, limited by the action to enjoin promoters of abusive tax shelters (sec. 7408) or the action to enjoin income tax return preparers (sec. 7407). This is in accordance with *U.S.* v. *Landsberger*, 692 F.2d 501 (8th Cir., 1982).

Effective Date

The increase in the penalty became effective for offenses occurring after July 18, 1984. The expanded authority to seek injunctions became effective after July 18, 1984.

d. Increased rate of interest for tax motivated transactions (sec. 144 of the Act and new sec. 6621(d) of the Code) [7]

Prior Law

Under prior and present law, if a tax is not paid on or before the last date prescribed for payment, interest must be paid by the taxpayer on the unpaid amount for the period from the last date prescribed for payment to the date of payment. Under prior law, the taxpayer paid interest at a uniform annual rate established under section 6621. In general, the last date prescribed for payment is the due date of the return determined without regard to any extension of time for payment and without regard to any notice and demand for payment issued by reason of a jeopardy assessment (but not later than the date notice and demand for the tax is made by the Secretary).

Under prior and present law, interest is paid by the United States on the overpayment of any tax at the annual rate established under section 6621. Generally, interest is paid with respect to a credit from the date of overpayment (generally the due date of the return) to the due date of the amount against which the credit is taken. In the case of a refund, interest is generally paid from the date of overpayment to the date (to be determined by the Secretary) preceding the date of the refund check by not more than 30 days. However, if the credit or refund is claimed in a late return, no interest is allowed or paid for the period before the date the

[7] For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 150; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 436-437; and H. Rep. No. 98-861 (June 23, 1984), pp. 984-986 (Conference Report).

return is filed. No interest is allowed on an overpayment of income tax if such overpayment is refunded within 45 days after the last date prescribed for filing the return of such tax (without regard to any filing extensions) or, if later, within 45 days after the date the return is filed.

Under prior and present law, interest rates under section 6621 are redetermined twice a year on the basis of the average adjusted prime rate charged by commercial banks during the six-month period ending September 30 (effective January 1 of the succeeding calendar year), and March 31 (effective July 1 of the same calendar year). In 1984, the annual rate was set at 11 percent.

Reasons for Change

Congress was concerned by the continued rise in the backlog of cases that involve tax shelter issues. The number of tax shelter cases in examination at the Internal Revenue Service was 195,000 at the end of fiscal year 1980, 250,000 at the end of 1981, 285,000 at the end of 1982, 335,000 at the end of 1983, and 331,000 at the end of 1984. Over the same period, the backlog of pending cases in the Tax Court was 34,865 at the end of fiscal year 1980, 45,921 at the end of 1981, 52,773 at the end of 1982, 58,333 at the end of 1983, and 63,598 at the end of 1984.

A number of the provisions of prior legislation had been designed, in whole or in part, to deal with the Tax Court backlog. Examples of these provisions are the increased damages assessable for instituting or maintaining Tax Court proceedings primarily for delay or that are frivolous or groundless (sec. 6673), the adjustment of interest rates (sec. 6621), the valuation overstatement and substantial understatement penalties (secs. 6659 and 6661), and the tax straddle rules (secs. 1092 and 1256).

Congress believed that, with the amendments made in this Act, the Tax Court has been given sufficient tools to manage its docket, and that the responsibility for effectively managing that docket and reducing the backlog now lies principally with the Tax Court. The Court has responded positively to several recent GAO recommendations, principally in the area of management initiatives. The Court has also begun to consolidate similar tax shelter cases and dispense with lengthy opinions in routine tax protester cases. Congress expected that the Court would take further action in these two areas, as well as assert, without hesitancy in appropriate instances, the penalties that Congress has provided.

Congress also believed that the Internal Revenue Service has significant responsibilities in reducing the Tax Court backlog. Congress believed that the Service's settlement policy should be fair and flexible, and only appropriate cases should be litigated. Although in the recent past the Service has offered to settle many tax shelter cases by permitting taxpayers to deduct out of pocket expenses, the Service no longer routinely offers this as a settlement. Congress believed that this was a constructive change in policy, in that a taxpayer should not expect to be able to deduct out of pocket expenses regardless of the circumstances of his case. Congress believed that the Service should assert, without hesitancy in appropriate circumstances, the penalties that Congress has provided. In particular, Congress believed that the negligence and fraud penalties are not currently being applied in a large number of cases where their application is fully justified. The Service has recently taken steps to eliminate the backlog in the Appeals Division.

Explanation of Provision

The Act increases the interest rate on substantial underpayments attributable to tax motivated transactions to 120 percent of the otherwise applicable rate. A substantial underpayment of tax attributable to one or more tax motivated transactions is any underpayment of income taxes for any taxable year that is attributable to one or more tax motivated transactions, if the amount of the underpayment for that year attributable to tax motivated transactions exceeds $1,000. A tax motivated transaction is (1) any valuation overstatement of 150 percent or more, (2) any activity with respect to which a loss or an investment tax credit is disallowed by reason of the at-risk rules, (3) any tax straddle, or (4) any use of any accounting method specified in regulations as potentially resulting in a substantial distortion of income.

The following deductions and other claimed tax benefits might be considered by the Secretary to arise from accounting methods that may result in a substantial distortion of income:

(1) deductions disallowed under section 464, relating to farming syndicates;

(2) in the case of a cash method taxpayer, interest deductions disallowed under section 461(g), relating to prepaid interest;

(3) interest deductions disallowed because they exceed the effective rate of interest, such as under the rule of 78's;

(4) improper deductions for syndication expenditures;

(5) deductions disallowed under section 267(a)(2), relating to transactions between related taxpayers with different accounting methods;

(6) failure to take into account deferred rental payments in accordance with the principles of section 467, as added by this Act; and

(7) deductions disallowed under the principles of section 461(i), as added by this Act, relating to prepayments of expenses by tax shelters.

For example, assume that a taxpayer's 1985 return shows an underpayment of tax of $600 due to a valuation overstatement, an underpayment of $600 due to a loss disallowed by the at-risk rules, and an underpayment of $600 due to improperly claiming an employee business expense. The underpayments due to the valuation overstatement and the at-risk rules are both due to tax-motivated transactions. Since the underpayment attributable to one or more tax-motivated transactions exceeds $1,000 (in the example it is $1,200), the increased interest rate of this provision applies (with respect to only the $1,200 underpayment). The result would be the same even if the taxpayer's tax liability decreased $600 because the taxpayer had not originally taken (but it was determined on audit that he was entitled to take) a charitable deduction for the full value of donated property because he had substantially undervalued it. This additional fact does not alter the computation of the substantial underpayment (described above).

The Act also gives the Secretary regulatory authority to specify other types of transactions that will be treated as tax-motivated and to provide that transactions specified as tax-motivated by the statute will no longer be treated as tax-motivated. He shall take into account the ratio of tax benefits to cash invested, the method of promoting this type of transaction, as well as other factors he considers relevant. The Tax Court is given jurisdiction to determine the portion (if any) of a deficiency that is a substantial underpayment attributable to tax-motivated transactions.

Effective Date

The provision is effective with respect to interest accruing after December 31, 1984, regardless of the date the return was filed. If the Secretary exercises his regulatory authority to extend or reduce the scope of this provision, the effective date of the extension or reduction shall be no earlier than the date the regulations are promulgated.

2. Information Reporting Provisions

a. Returns relating to mortgage interest received in a trade or business from individuals (sec. 145 of the Act and new sec. 6050H of the Code) [8]

Prior Law

There was no requirement under prior law that recipients of mortgage interest report interest received to the Internal Revenue Service.

Reasons for Change

Congress believed that a provision requiring recipients of mortgage interest payments aggregating $600 annually to report the interest received to the Internal Revenue Service (with a copy to the payor) would materially assist the Service in verifying the accuracy of claimed mortgage interest deductions. Internal Revenue Service studies indicate that a significant percentage of all overstated deductions involves overstatement of interest deductions.

Explanation of Provision

The Act requires that a person who, in the course of his trade or business, receives interest on obligations secured by real property must report to the Internal Revenue Service payments from a payor aggregating $600 or more and provide a copy of that report to the payor.

The report must include the payor's name, address, and taxpayer identification number, the aggregate amount of mortgage interest received during the calendar year, and such other information as the Secretary may prescribe. For this purpose, mortgage interest is any interest on an obligation secured by an interest in real property (including, however, interest payable under a contract for deed) and amounts paid in lieu of interest for which a deduction is allowed. A person, for purposes of this provision, includes any governmental unit that receives mortgage interest payments. The trade or business requirement does not, however, apply to a governmental unit. The return by the governmental unit must be made by the officer or employee appropriately designated to make these returns. In addition to furnishing reports on $600 or more of interest on any mortgage for any calendar year to the Internal Revenue Service, the payment recipient must furnish to each payor

[8] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 152; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1353-1354; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 147; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 429-431; and H. Rep. No. 98-861 (June 23, 1984), pp. 986-987 (Conference Report).

an annual statement of the amount of mortgage interest received from that payor in the calendar year. These statements must be made on or before January 31 of the year following the calendar year for which the return is made. The report to the Internal Revenue Service must be made at the time the Secretary may require by regulations.

If an individual with respect to whom a report is made did not pay the entire amount of interest himself (because, for example, he is the nominee of another), Congress intended that that individual report the identity of the individuals actually making the payments and the amounts they paid to the Internal Revenue Service and to those individuals. Congress intended that this function similarly to the nominee reporting that currently exists with respect to interest and dividend payments.

Congress chose a $600 reporting threshold (as opposed to a higher figure, such as $2,300) because it provides more complete reporting, which consequently reduces the likelihood that the Internal Revenue Service will have to contact a taxpayer concerning claimed deductions.

The Act provides that reporting is required only on payments received from an individual. Under the Act, the $600 aggregate annual reporting threshold applies on an obligation by obligation basis. Interest received on two different obligations secured by the same real property does not have to be aggregated into one report; thus, interest on each obligation may be reported separately. The Act also provides that the Secretary may provide exceptions from this reporting requirement where such exceptions are consistent with effective reporting of mortgage interest and the matching of these reports with a specific line on the tax return. Therefore, the Secretary may, if he considers it appropriate, provide for an exception from reporting for interest paid on credit cards that are secured by real property. This exception would be appropriate if the Secretary determines that such interest is most likely to be reported on returns as interest on credit cards rather than home mortgage interest. Congress did not intend that the Secretary except from reporting interest that is likely to be reported on Schedule A of Form 1040 as home mortgage interest.

The Act provides the Secretary with authority to issue regulations to eliminate duplicative reports. The Act provides that, unless the Secretary provides otherwise in regulations, in the case of interest received by one person on behalf of another, only the first person receiving the interest is required to report to the payor and to the Internal Revenue Service. Congress intended that the Secretary coordinate the requirement that a statement be furnished to the payor under this provision with other requirements, such as those of Federal mortgage programs, that similar statements be furnished, so that duplicative reporting is minimized.

Congress intended that recipients of mortgage interest will require the payor to furnish his taxpayer identification number as part of the mortgage loan approval or closing process for mortgage loans entered into after December 31, 1984.

With respect to mortgage loans in existence on December 31, 1984, Congress intended that the Secretary would require recipients of mortgage interest to request, at least once every year, from each payor the payor's taxpayer identification number, unless the recipient already has the payor's number in its accounting system. Thus, recipients will continue to ask for the taxpayer identification number at least once every year until the recipient obtains the number. The Secretary should permit these requests for a payor's taxpayer identification number to be included in the recipient's regular mailings of either payment coupon booklets or annual statements to the payor. Recipients should not be required to make separate mailings of these requests, unless the recipient does not otherwise contact the payor at least once each calendar year. The first request should be made as soon as practicable, but in no event later than with the first mailing by the recipient to the payor in 1985. Recipients should notify payors that the Internal Revenue Service requires the payor to furnish its taxpayer identification number in order to verify the payor's deduction for mortgage interest and that the payor is subject to a $50 penalty by the Internal Revenue Service if the payor fails to furnish its taxpayer identification number. If the interest recipient makes the annual requests described above, and properly and promptly processes the responses, it should not be subject to any penalty for failure to include a TIN on its information return to the Internal Revenue Service because the payor's failure to supply the requested number would constitute reasonable cause for failure to supply the number to the Internal Revenue Service.

The penalty for failure to file required reports with the Internal Revenue Service and to furnish statements to taxpayers is similar to that imposed on failures to make other information reports and statements. Thus, the penalty is $50 per failure, subject to a maximum of $50,000 for any calendar year. The penalty is not applicable if the failure is due to reasonable cause and not to willful neglect. If, however, the failure to file required reports with the Internal Revenue Service is due to intentional disregard of the filing requirements, the penalty is not less than $100 for each failure and the $50,000 limitation does not apply.

Effective Date

The provision is generally effective with respect to amounts received after December 31, 1984. However, no penalty is imposed for failures to furnish identification numbers with respect to amounts received before January 1, 1986, if those amounts relate to an obligation in existence on December 31, 1984. This exception from penalties for existing mortgages applies only to the penalty for failure to furnish the payor's identification number on the return. Congress intended that failure to furnish the return itself still be subject to penalty.

b. Returns relating to cash received in a trade or business (sec. 146 of the Act and new sec. 6050I of the Code)[9]

Prior Law

A number of provisions of the Code require that information reports be filed on specified transactions. Under prior law there was, however, no specific requirement in the Code that large cash transactions be reported.

In addition to the information reporting required by the Code, the Bank Secrecy Act authorizes the Secretary to require reporting of certain financial transactions. These provisions are not in the Code. Under these rules, certain banks and other financial institutions are required to report cash transactions (including deposits and withdrawals) of more than $10,000. The Treasury regulations provide a number of exceptions to this reporting requirement. Also, persons who bring or send more than $5,000 in cash or other bearer instruments into or out of the United States must report the event to the United States Customs Service. Finally, a United States taxpayer who files a tax return is required to notify the Internal Revenue Service, where provided for on the tax return, of the existence of a foreign bank account or other foreign financial account that he controls or in which he has an interest. If the amount in the account exceeds $1,000, then the amount must be reported on a separate form to the Treasury Department.

Bank Secrecy Act information is compiled by the Treasury Department and made available to agents of the Internal Revenue Service.

Reasons for Change

Congress was concerned that approximately 80 percent of the revenue lost through noncompliance is attributable to the underreporting of income. For 1981, the Internal Revenue Service estimated that taxpayers filing returns failed to report $134 billion of income and nonfilers failed to report $115 billion. This $250 billion of underreporting reduced tax receipts by an estimated $55 billion. Unreported income connected with illegal activities was estimated to result in an additional $9 billion of lost revenue. Congress believed that reporting on the spending of large amounts of cash would enable the Internal Revenue Service to identify taxpayers with large cash incomes.[10]

Explanation of Provision

A person engaged in a trade or business who receives, in the course of the trade or business, more than $10,000 in cash or foreign currency in one or more related transactions must report it to

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[9] For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 147; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 429-431; and H. Rep. No. 98-861 (June 23, 1984), pp. 987-989 (Conference Report).

[10] Information reporting on large amounts of cash was suggested to Congress by the Federal Taxation Division of the American Institute of Certified Public Accountants in its January 1983 report entitled "Underreported Taxable Income: The Problem and Possible Solutions" (pp. 7, 34), and by the New York State Bar Association Tax Committee in its April 20, 1982 comments on the Taxpayer Compliance Improvement Act of 1982 (Exhibit A, pp. 8-9).

the Internal Revenue Service and provide a statement to the payor. For purposes of this provision, cash is currency; it does not include checks, traveller's checks, drafts, money orders, or other cash equivalents. A transaction subject to reporting is any receipt of cash including receipt in connection with the purchase of goods or services, the purchase or exchange of property, the opening of a deposit or credit account, the purchase of gambling chips, or any similar transaction.

This new reporting requirement is imposed with respect to any receipt of cash in connection with a trade or business, whether or not the receipt constitutes income in the trade or business. Thus, reporting is required whether or not consideration is returned for the cash and whether or not the cash is received for the recipient's own account or for the account of another. For example, if a title company receives more than $10,000 in cash from the purchaser of real estate as his downpayment, the title company must report the receipt of that cash, even though it receives the cash on behalf of the seller.

The recipient of the cash will be required to report the name, address and taxpayer identification number of the payor, the amount of cash received, the date and nature of the transaction, and such other information as the Secretary may require. In addition to furnishing reports on each cash transaction to the Internal Revenue Service, the recipient of the cash must furnish each payor an annual statement aggregating the amounts of cash received from him. This statement must be furnished on or before January 31 of the year following the year of the reportable event.

Any taxpayer specified under this provision who receives more than $10,000 in cash in one or more related transactions is required to report those transactions. For example, assume that an individual purchases a $8,000 item and a $1,500 item at an auction. The auction house adds a 10% buyer's premium and the 5% local sales tax. The taxpayer pays his $10,972.50 bill in cash. The auction house must report on that transaction. The auction house could not avoid the reporting requirement by presenting two separate bills of $9,240 and $1,732.50.

Reporting is not required on payments (a) that are received in a transaction reported under the Bank Secrecy Act if the Secretary determines that the report under this provision would duplicate the report under the Bank Secrecy Act, or (b) that are received by certain specified financial institutions within the meaning of the Bank Secrecy Act.

With respect to these specified financial institutions, Congress did not intend to affect the detailed reporting rules and exceptions which Treasury had previously developed. Certain categories of financial institutions that are not specified as exempt from reporting under this provision, such as certain dealers in precious metals, stones, or jewels, pawnbrokers, loan or finance companies, insurance companies, and travel agencies, have generally been exempted by Treasury from Bank Secrecy Act reporting. These entities are required to report under this new provision. To the extent that Treasury also requires that these entities report transactions under the Bank Secrecy Act, the Secretary may provide that duplicative reports that would be made on those transactions pursuant to this provision need not be made.

Congress understood that the Treasury was considering extending certain Bank Secrecy Act reporting to casinos and other establishments. To avoid duplicative reporting requirements, the Secretary has discretion under this Act and the Bank Secrecy Act to review the obligations imposed under the Bank Secrecy Act and to eliminate any reporting required under this Act if the Bank Secrecy Act reporting, in substance, provides for the reporting of transactions required to be reported under this Act with respect to the information that must be provided to the Treasury.

The penalty for failure to file required reports with the Internal Revenue Service and to furnish statements to taxpayers is similar to that imposed on failures to make other information reports and statements. Thus, the penalty is $50 per failure, subject to a maximum of $50,000 for any calendar year. The penalty is not applicable if the failure is due to reasonable cause and not to willful neglect. If, however, the failure to file required reports with the Internal Revenue Service is due to intentional disregard of the filing requirements, the penalty is not less than $100 for each failure and the $50,000 limitation does not apply.

Effective Date

The provision is effective for amounts received after December 31, 1984.

c. Provisions relating to individual retirement accounts (sec. 147 of the Act and secs. 219, 408, and 6693 of the Code) [11]

Prior Law

Under prior and present law, an individual may deduct amounts contributed to an individual retirement account (IRA). A contribution for a taxable year is considered as having been made on the last day of the taxable year, if the contribution is made not later than the time prescribed for filing the return for the taxable year. Under prior law, this date included any extensions for filing the return.

Under prior and present law, the trustee of an individual retirement account or individual retirement annuity is required to report to the Secretary of the Treasury and the individual for whom the IRA is maintained on contributions, distributions and other relevant matters required under regulations issued by the Secretary. The time and manner in which the reports are to be filed with the Secretary and furnished to the individual are prescribed in regulations.

In the event of a failure to file a report regarding an IRA at the time and in the manner required, the person responsible for making the reports was required under prior law to pay a penalty

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[11] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 157; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1362-1363; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 152; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 439-440; and H. Rep. No. 98-861 (June 23, 1984), pp. 989 (Conference Report).

of $10 for each failure, unless it was shown that the failure to file was due to reasonable cause.

Reasons for Change

Congress learned that the annual IRA reports were not being filed in the time and manner that was desired. When reports were filed, the information concerning contributions made during the course of a year was stated as a single total and did not distinguish between contributions that may have been made for different years. As a result of these shortcomings, Congress decided to reaffirm the Secretary's authority in prior law to require reporting as to each year for which contributions are made and to increase the penalty for failure to file in the manner and by the time required.

Additionally, Congress was concerned that the ability of taxpayers to make contributions between the unextended due date of the return for the taxable year and the due date with extensions impeded the Secretary's ability to monitor deductions for these contributions.

Explanation of Provision

Under the Act, the report to the Internal Revenue Service and the owner of the IRA must identify the years to which IRA contributions relate. The trustee may require that the owner of the IRA certify as to which year a contribution relates and, except in unusual circumstances, the trustee may rely on that certification.

The date by which this report must be provided to the Internal Revenue Service and the periods to which the report relates are to be specified by the Secretary in regulations. Congress intended that generally trustees would be required to report only once a year on the cumulative total of contributions relating to a particular taxable year. The Secretary may, however, provide for more frequent reporting if he determines that it is appropriate to do so. As to the date by which the report must be provided to the Internal Revenue Service, the Secretary could, for example, require reporting by the end of May on all IRA contributions relating to the taxable year with respect to which the individual's tax return was due on the preceding April 15.

The penalty for each failure to provide a report on contributions or withdrawals is increased to $50.

The Act also provides that contributions must be made by the due date of the return (without extensions).

Effective Date

The requirements that reports identify the years to which contributions relate and that contributions be made on or before the unextended filing date for the tax return are effective for contributions made after December 31, 1984. The increase in the penalty became effective for failures to report occurring after July 18, 1984.

d. Returns relating to foreclosures and abandonments of security (sec. 148 of the Act and new sec. 6050J of the Code) [12]

Prior Law

Under prior and present law, the acquisition by a creditor of property which served as security for a loan may be a taxable event to both the lender and the borrower. The tax effects vary depending upon whether the loan is thereby discharged in whole or in part, whether the debt was recourse or nonrecourse, whether the acquisition was by way of a foreclosure sale or abandonment, or otherwise.

In general, foreclosure events are treated as sales or exchanges between the parties to the extent of the fair market value in the case of recourse debt, and to the extent of the debt in the case of nonrecourse debt. In addition, the foreclosure or other acquisition by a lender of property which was security for a loan in full or partial satisfaction of the loan, or the abandonment of the property, may (in certain cases), give rise to discharge of indebtedness income to the borrower.

Special rules apply with respect to foreclosures, or other acquisitions of security, by thrift institutions and certain reacquisitions by sellers of real property when the seller took back a purchase money obligation.

Under prior law, there was no specific requirement of reporting on foreclosures and abandonments of security.

Reasons for Change

Congress believed that gain on foreclosure and other disposition events and discharge of indebtedness income may have been unreported under prior law, because there was no reporting requirement designed to encourage consistent treatment by the lender and the borrower on a foreclosure, abandonment or other disposition of property which is security for indebtedness. Neither was there a reporting requirement to encourage the correct treatment of discharge of indebtedness income in recourse debt cases. In addition, these events may be difficult for the Internal Revenue Service to detect.

Explanation of Provision

Under the Act, any person who, in connection with a trade or business, lends money secured by property, must report to the Secretary any foreclosure or other acquisition of property in full or partial satisfaction of a debt secured by that property. In addition, the lender must report the abandonment by the borrower of any property which is security for a loan by the lender when the property is first determined to have been abandoned. A person, for purposes of this provision, includes any governmental unit. The trade

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[12] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 153; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1355-1356; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 148; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 432-433; and H. Rep. No. 98-861 (June 23, 1984), p. 990 (Conference Report).

or business requirement does not, however, apply to a governmental unit. The return must be made by the officer or employee appropriately designated to make these returns. Reports must be filed on foreclosures and abandonments with respect to purchase money mortgages on real property. No reporting is required if the loan is to an individual and is secured by an interest in tangible personal property that is not held for investment and that is not used in a trade or business, such as consumer loans for personal property. Thus, both the nature of the security and the use to which the property is put must be personal in order for the loan to qualify for this exemption from reporting.

These returns must include the name, address, and taxpayer identification number of the borrower, the amount of the debt, the type of security for the debt, the date and method of acquisition, a general description of the nature of the property and the indebtedness, the amount of the indebtedness and the portion of the indebtedness satisfied by the foreclosure, the amount of the indebtedness at the time of the abandonment, and such other information as the Secretary may prescribe. In each case, a duplicate report must be provided to the debtor by January 31 of the year following the year of the reportable event.

The Secretary is given authority to issue regulations that specify that a transfer of property that secures indebtedness to any person other than the debtor shall be treated as an abandonment of the property.

The penalty for failure to file required reports with the Internal Revenue Service and to furnish statements to taxpayers is similar to that imposed on failures to make other information reports. Thus, the penalty is $50 per failure, subject to a maximum of $50,000 for any calendar year. The penalty is not applicable if the failure is due to reasonable cause and not to willful neglect. If, however, the failure to file reports with the Internal Revenue Service is due to intentional disregard of the filing requirements, the penalty is not less than $100 for each failure and the $50,000 limitation does not apply.

Effective Date

The provision is effective for foreclosures and abandonments after December 31, 1984.

e. Returns relating to exchanges of partnership interests (sec. 149 of the Act and new sec. 6050K of the Code) [13]

Prior Law

Under prior and present law, gain or loss is not recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership. The basis of an interest in a partnership that is acquired by a contribution of property to the partnership is the adjusted

[13] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 158; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1364-1365; and H. Rep. No. 98-861 (June 23, 1984), pp. 990-991 (Conference Report).

basis of the property to the contributing partner at the time of contribution increased by the amount of any gain recognized to the contributing partner.

Under prior and present law, a sale or exchange of a partnership interest generally is treated as a sale or exchange of a capital asset.

Exchanges of interests in a partnership often involve unrealized receivables and inventory items. The amount of money, or the fair market value of unrealized receivables or appreciated inventory items, received in exchange for all or a part interest in a partnership, is considered to be ordinary income realized from the sale or exchange of property.

Under prior law, there was no reporting required on exchanges of partnership interests.

Reasons for Change

Under prior law, it was often difficult for the Internal Revenue Service to carry out effectively its partnership audit activity because partnership returns did not provide adequate information concerning the elements (described in sec. 751(a)) in a sale or exchange of property related to partnership interests. This information is needed to determine proper allocation of capital gains or losses and ordinary income. At times, the exchanges of partnership property are also related to tax shelter schemes, some of which might be characterized as abusive tax shelters.

Therefore, Congress decided to add a new reporting requirement that will relate to sales or exchanges of partnership interests involving certain receivables and inventory items.

Explanation of Provision

Under the Act, the transferor partner must notify the partnership when a sale or exchange of a partnership interest involving unrealized receivables or appreciated inventory occurs. Once the partnership has notice of the sale or exchange, it must report to the Internal Revenue Service, the transferor, and the transferee on the sale or exchange, except as provided in Treasury regulations. The report must state the name and address of the transferor, the transferee, and the partnership. The report must also include any other information that the Secretary may require in regulations. Congress anticipated that the Secretary could require reporting of information that would enable the Secretary to determine the amount of ordinary income realized by the transferor in the transfer. The report to the transferor and the transferee must be furnished by January 31 of the year following the year in which the sale or exchange occurred. The report to the Internal Revenue Service must be made in the time and manner required by the Secretary.

The penalty for failure to notify the partnership of the exchange of partnership interests, to file required reports with the Internal Revenue Service, and to furnish statements to taxpayers, is similar to that imposed on failures to make other information reports and statements. Thus, the penalty is $50 per failure, subject to a maximum of $50,000 for any calendar year. The penalty is not applicable if the failure is due to reasonable cause and not to willful neglect. If, however, the failure to file required reports with the Internal Revenue Service is due to intentional disregard of the filing requirements, the penalty is not less than 10 percent of the aggregate amount not properly reported and the $50,000 limitation does not apply.

Effective Date

The provision is effective for exchanges after December 31, 1984.

f. Statements required in the case of certain substitute payments (sec. 150 of the Act and sec. 6045 of the Code) [14]

Prior Law

A broker who holds stock in street name for a customer may lend that stock to another customer for use in a short sale. The short-seller sells the borrowed stock with the expectation that the price of the stock will decline and expects to be able to purchase stock to return to the lending broker at a price below the proceeds of the sale. If a dividend is paid on the borrowed stock, the short-seller must pay the lender an amount in lieu of the dividend. The actual dividend is received by the purchaser in the short sale. If the borrowed stock belonged to a corporate client of the broker, the corporation is not entitled to the dividends received deduction on the amount of the payment received in lieu of the dividend.

A broker may engage in a similar transaction with tax-exempt bonds. Payments of interest on the bonds are tax-exempt to the purchaser in the short sale, while the interest-substitute payments to the client of the broker are not tax-exempt.

Under prior law, there was no reporting required on substitute payments if a broker lent securities of a customer held in street name in connection with a short sale. Absent reporting, the dividends received deduction or an interest exclusion may have been claimed more than once, even though only the purchaser in the short sale is entitled to the deduction or exclusion.

Reasons for Change

Congress understood that the inadequacy of the reporting requirements under prior law led to situations in which the dividends received deduction was being claimed more than once with respect to the same stock because corporations who deposited stock with their broker were unaware that the stock had been lent out in connection with a short sale and that the payment they received was not a dividend but a dividend-substitute payment. A similar situation existed with respect to interest on tax-exempt bonds. Congress decided that a change in the broker reporting requirements was needed so that customers of brokers would be informed of the action on the short sale so that they would not take improperly the

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[14] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 159; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), p. 1366; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 153; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 441-442; and H. Rep. No. 98-861 (June 23, 1984), p. 991 (Conference Report).

dividends received deduction or the exemption for interest on tax-exempt bonds.

Explanation of Provision

A broker is required to furnish a statement to the taxpayer if the broker lends securities for use in a short sale or similar transaction and the broker receives a dividend payment, tax-exempt interest, or other items that the Secretary prescribes by regulations, on behalf of the customer. The Secretary is given regulatory authority to require that a copy of the statement be furnished to the Secretary. The Secretary should exercise this authority for all types of payments with respect to which such a copy could be useful to the Secretary. The Secretary should also provide that no return regarding payments of dividends (sec. 6042(b)(1)(B)) need be made if it unnecessarily duplicates any return required to be made under this provision.

Effective Date

This provision is effective for payments after December 31, 1984.

g. Reporting of State and local tax refunds (sec. 151 of the Act and sec. 6050E of the Code) [15]

Prior Law

Under prior and present law, an information return must be filed with the Secretary and a copy must generally be furnished to the taxpayer with respect to any State or local government income tax refund, credit, or offset aggregating $10 or more during the calendar year which is paid or credited to an individual. Under prior law, copies of the reports to taxpayers were required when amounts were paid over or credited regardless of whether they were taxable to the taxpayer in that taxable year. Thus, an amount paid over or credited was reportable to the taxpayer even though it was not taxable because the taxpayer received no tax benefit. Similarly, if an amount was credited to reduce the future liability of the taxpayer, it was reportable to the taxpayer once credited even though the liability against which the credit would be taken had not yet arisen. The return required by this provision must report the aggregate amount of any such refund payments, credits, or offsets, and the recipient's name and address. State governments can satisfy their return obligations under this provision through voluntary information exchange agreements with the Internal Revenue Service.

Under temporary regulations, the Treasury has provided that reporting is not required when the officer making the refund determines that that individual received no Federal tax benefit from the tax payment to which the refund relates.

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[15] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 155; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1359-1360; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 163; S. Prt. 98-169, Vol. I (April 2, 1984), p. 457; and H. Rep. No. 98-861 (June 23, 1984), pp. 991-992 (Conference Report).

Reasons for Change

Many taxpayers who receive income tax refunds from the State and local governments in whose taxing jurisdiction they reside receive no tax benefit under the Federal income tax because they do not itemize their deductions. These taxpayers employ the zero bracket amount in lieu of itemizing their deductions, and changes in the net amount of State and local income taxes paid after refunds have no effect on the taxpayer's marginal tax bracket.

The intent of Congress in adopting reporting on State and local refunds in TEFRA in 1982 was to assure that taxpayers report these refunds on their federal income tax returns when they had previously received a tax benefit through the deduction of State and local government income tax payments. Taxpayers who do not itemize deductions do not receive such a tax benefit and, thus, have no reportable income from a refund of State or local government taxes.

Explanation of Provision

The Act codifies existing regulations by providing that no reporting to the taxpayer is required if it is determined (in the manner provided in Treasury regulations) that the taxpayer did not itemize deductions. Reports relating to itemizers must be furnished to them in January of the year following the year of the refund.

All refunds, whether made to itemizers or non-itemizers, must be reported to the Internal Revenue Service. Reporting to the Internal Revenue Service should not be burdensome on the States since most States have entered into exchange of information agreements that already provide that this information is to be furnished to the Internal Revenue Service. Congress believed that reporting in January by the State and local governments to taxpayers who itemize is a significant compliance tool. The Secretary should seriously consider terminating any exchange of returns or return information under section 6103 with a State that does not report refunds to the taxpayer.

Effective Date

The provision is effective with respect to payments of refunds, and credits and offsets made, after December 31, 1982. That was the effective date of the original TEFRA provision requiring reporting and the Treasury regulations thereunder. However, Congress expected that no punative action will be taken against any State or local government or any officer or employee of a State or local government who failed to provide, before January 1, 1985, to taxpayers a statement required to be made under this provision.

h. Furnishing of TIN under backup withholding (sec. 152 of the Act and sec. 3406 of the Code)[16]

Prior Law

Section 3406(e) provides that if a payee of any reportable payment does not furnish his taxpayer identification number (TIN) to a payor in the manner required, backup withholding will apply to any reportable payment made by the payor to the payee. A reportable payment is a payment required to be shown on returns under sections 6041 (relating to information at source), 6041A(a) (relating to remuneration for services), 6042(a) (relating to dividends), 6044 (relating to patronage dividends), 6045 (relating to returns of brokers), 6049(a) (relating to interest), and 6050A (relating to certain fishing boat operators). The Treasury Department has issued temporary regulations that require that the payee certify that his TIN is correct under penalties of perjury for payments of interest, dividends, patronage dividends, and amounts subject to broker reporting. The payee may initially furnish his taxpayer identification number in any manner for other types of reportable payments under the temporary regulations.

Reasons for Change

Congress believed that in general the Secretary's authority to require that the payee initially certify that his TIN is correct under penalties of perjury should, absent evidence of serious compliance deficiencies by payees, be limited to payments of interest, dividends, patronage dividends, and amounts subject to broker reporting.

Explanation of Provision

The Act codifies existing regulations by providing that the Secretary's authority to require that a TIN be furnished under penalties of perjury is restricted to interest, dividends, patronage dividends, and amounts subject to broker reporting. This restriction applies only to the initial furnishing of a TIN, such as when an account is opened. This is only one of the four conditions that can trigger backup withholding. This restriction does not apply to requests for a TIN in connection with any of the other conditions under which backup withholding may be imposed.

Effective Date

The provision became effective on July 18, 1984.

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[16] For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 162; S. Prt. 98-169, Vol. I (April 2, 1984), p. 456; and H. Rep. No. 98-861 (June 23, 1984), pp. 992-993 (Conference Report).

3. Other Compliance Provisions

a. Modifications to charitable contribution rules and incorrect valuation penalties (sec. 155 of the Act and secs. 170, 6659, and new secs. 6050L and 6660 of the Code) [17]

Prior Law

Substantiation requirements

The Code provides expressly that a charitable contribution is deductible only if verified in the manner required by Treasury regulations (sec. 170(a)(1)). Pursuant to this statutory rule, certain substantiation requirements have been set forth in Treas. Reg. sec. 1.170A-1(a)(2), including additional information that must be attached to the donor's return in the case of donations of property for which a deduction exceeding $200 is claimed.

Under prior law, there were no specific requirements in the statute or regulations that donors must obtain qualified appraisals to verify the fair market value of donated property in order to obtain a charitable deduction, or that donees must furnish information reports to the Internal Revenue Service and the donor on dispositions of donated property.

Overvaluation penalties

A graduated penalty is imposed for valuation overstatements by individuals, closely held corporations, and personal service corporations (sec. 6659), including valuation overstatements made in claiming a charitable deduction. Under prior law, the penalty (addition to tax) was as follows for any overvaluation on an income tax return—

(1) for claimed valuations of 150 percent or more, but not more than 200 percent, of the correct value, 10 percent of the tax liability underpayment;

(2) for claimed valuations of more than 200 percent, but not more than 250 percent, of the correct value, 20 percent of the tax liability underpayment; and

(3) for claimed valuations exceeding 250 percent of the correct value, 30 percent of the tax liability underpayment.[18]

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[17] For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 154; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 443-47; and H. Rep. No. 98-861 (June 23, 1984), pp. 993-99 (Conference Report).

[18] For example, assume that an individual collector (with a 50-percent marginal rate) donates a painting to a university museum for its collection, that the donor claims a value of $500,000 on her income tax return for the painting, and that the painting is finally determined to have a fair market value of $100,000. As a result of overstating the value of the painting, the taxpayer had claimed a $500,000 charitable contribution deduction for the year in which the contribution was made, thereby reducing her tax liability by $250,000. Had the taxpayer claimed only the charitable deduction to which she was entitled ($100,000), her tax liability would have been re-

Continued

No penalty is imposed if the tax liability underpayment for a taxable year attributable to the valuation overstatement is less than $1,000. (The penalty does apply in instances where the taxpayer claims an amount for a charitable donation of property but in fact no property was actually contributed, assuming the resulting underpayment is $1,000 or more.) Under prior law, the penalty did not apply to any property that, as of the close of a taxable year for which there was a valuation overstatement, had been held by the taxpayer for more than five years. Also, the penalty did not apply to incorrect valuations for estate and gift tax purposes.

Under prior law, the Internal Revenue Service had discretionary authority to waive all or part of the penalty on a showing by the taxpayer both that there was a reasonable basis for the valuation claimed on the return and also that the claim was made in good faith.

Reasons for Change

The Congress recognized that the tax benefits provided to taxpayers who contribute appreciated capital-gain property to charities create opportunities for overvaluations because the donor is entitled to deduct the fair market value of the property, but does not realize taxable gain equal to the appreciation. One way to reduce these opportunities to overvalue would be to eliminate the advantage that charitable gifts of appreciated property have over gifts of cash. The Congress understood, however, that many charitable organizations depend on this tax benefit for fund-raising and as a means of acquiring valuable property.

At the same time, the Congress recognized that in recent years, opportunities to offset income through inflated valuations of donated property have been increasingly exploited by tax shelter promoters. Under typical tax shelter promotions, individuals acquire objects such as limited edition lithographs, books, gems, and the like, hold the property for at least the capital gains holding period, and then contribute the items to a museum, library, educational institution, or other qualified donee at their "appreciated" fair market value. The shelter package may include an "independent" appraisal, and the potential donor may be assured that his or her subsequent gift will be accepted by a charitable organization.

Also, the Congress was concerned with situations, not involving organized tax shelters, where individuals overvalue donated property (whether or not capital-gain or appreciated property). While some of the most flagrant overvaluation cases that have come to public attention have involved gems donated to museums, deductions denied by the Internal Revenue Service on the basis of overvaluation also have involved contributions of other types of property, such as interests in real estate, and contributions made to other types of donees, such as educational institutions. Organizations claiming to be eligible to receive tax-deductible contributions may advertise nationally seeking contributions of property, e.g., real estate that the owners have been unable to sell.

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duced by only $50,000. Thus, because of the valuation overstatement, the taxpayer underpaid her income tax liability by $200,000. Accordingly, the addition to tax applicable to the valuation overstatement is $60,000 (i.e., 30 percent of $200,000).

The Congress was aware that in various instances, the Internal Revenue Service had succeeded in challenging overvaluations claimed by donors, and had initiated a special audit program to combat charitable contribution tax shelters. However, it is not possible to detect all or even most instances of excessive deductions by relying solely on the audit process. Because valuation of some types of property cannot be determined by reference to readily available and accepted valuation tables, taxpayers may continue to play the "audit lottery" and claim excessive charitable deductions. The Congress also was concerned that widespread publicity given to the extent of gross overvaluations by some donors encourages other taxpayers, who are not in a position to claim inflated deductions for donations of property such as art works, gems, antiques, rare books, real estate, etc., to have disrespect for the tax law.

Because of these concerns, the Congress concluded that stronger substantiation requirements and tighter overvaluation penalties should apply to charitable contributions of property. The requirement that the donor must obtain an appraisal by a qualified and independent appraiser where the claimed value exceeds certain dollar amounts, and must attach a summary thereof signed by the appraiser to the return, is intended to ensure that in more instances than under prior law, the correct value of such donated property will be claimed by the donor on the return in the first instance. The Congress believed that these substantiation requirements will prove more effective in deterring taxpayers from inflating claimed deductions than relying solely on the uncertainties of the audit process and on penalties imposed on those overvaluations that are detected on audit.

Further, the Congress believed that the incorrect valuation penalty should apply regardless of the length of time that the property was held before the contribution, and that it is equally important to deter incorrect valuations for estate and gift tax purposes as for income tax purposes. Accordingly, the Congress concluded that the prior-law incorrect valuation penalty generally should be modified in certain respects, including applying the penalty to incorrect valuations in the case of estate and gift tax returns, and that additional modifications to the penalty were needed in the case of charitable contribution overvaluations. Also, the Congress believed that compliance would be facilitated by requiring donees that dispose of certain donated property within two years after contribution to report on the disposition to the Internal Revenue Service and the donor. The Congress believed that these provisions of the Act will be helpful in deterring incorrect valuations and will assist the Internal Revenue Service in administering the law. The Congress noted that while the new substantiation requirements do not apply to contributions made prior to 1985, the tighter overvaluation penalties are applicable to deductions claimed on the donor's 1984 return (i.e., the return due April 15, 1985, for individuals) for contributions made in 1984.

The Congress understands that the Treasury Department remains concerned whether the substantiation and penalty provisions of the Act will prove sufficient to preclude taxpayers from overvaluing charitable donations of property in all circumstances. This concern relates principally to tax shelter promotions that exploit the deductibility of appreciation in capital-gain assets, and to other situations where individuals buy items on their own initiative specifically for contribution after expiration of the capital gains holding period, or overvalue items that they have held for long periods before donating them to a charity.

The Congress expects the Treasury and Internal Revenue Service to monitor the effectiveness of the new provisions and to notify the tax-writing committees if there are any continuing valuation concerns that should be addressed by further legislation, including any valuation concerns in the case of donated property where the claimed value is not large enough to trigger the new substantiation requirements. In this connection, the Congress noted that the Treasury has express authority under Code section 170(a)(1) to specify by regulations the manner in which charitable contributions must be substantiated in order to be deductible.

The Treasury and Internal Revenue Service are encouraged to utilize fully this regulatory authority and the compliance tools available under present law with respect to improper or overvalued claims of charitable deductions, such as negligence and fraud penalties, and other administrative procedures such as the findings of the Art Advisory Panel. Also, the Congress expects the Treasury to call the attention of the tax-writing committees to any other compliance problems relating to charitable deductions—for example, where the taxpayer or return preparers may claim a deduction based on records of checks drawn in the name of a charity, but where in fact the checks represent payments for goods (purchased directly from the charitable organization or at a fund-raising auction or bazaar) rather than charitable contributions. To the extent such compliance problems cannot be adequately addressed pursuant to the Treasury's regulatory authority under section 170(a)(1), the Treasury is to recommend to the tax-writing committees any appropriate legislative solutions.

Explanation of Provisions

Substantiation requirements (sec. 155(a) of the Act)

General rule

The Act requires that prior to January 1, 1985, the Treasury Department is to issue temporary (or final) regulations under section 170 that incorporate the charitable deduction substantiation requirements as set forth in section 155(a) of the Act. Accordingly, pursuant to Code section 170(a)(1), which expressly allows a charitable deduction only if the contribution is verified in the manner specified by Treasury regulations, no deduction (either for appreciation or basis) is allowed for any contribution of property for which an appraisal is required under the Act unless the appraisal requirements are satisfied.

Applicability

The appraisal requirements apply to charitable deductions claimed under Code section 170 by an individual, a closely held corporation,[19] or a personal service corporation.[20] In the case of partnerships or S corporations, the requirements apply where a partner or S corporation shareholder includes a deduction on his or her return on account of a charitable contribution of such property by the partnership or S corporation.

The appraisal requirements do not apply to contributions of securities for which (as of the date of the contribution) market quotations are readily available on an established securities market.[21] In the case of all other contributions of property, the appraisal requirements apply if the amount claimed as a charitable deduction by the taxpayer on his or her income tax return for a year exceeds $5,000 for any single item of such property, or exceeds $5,000 in the aggregate for similar items of property donated during the year (such as a group or number of stamps, coins, lithographs, or books). However, in the case of a donation of stock that is not exempt from the appraisal rules (i.e., stock for which market quotations are not readily available on an established securities market), the appraisal requirements apply if the amount claimed as a charitable deduction by the taxpayer on his or her tax return for a year exceeds $10,000 in the aggregate for all donations of such stock to all donees.

For purposes of this rule, similar items of donated property are aggregated whether all such items are donated by the donor to only one donee, or some such items are donated to a particular donee and others are donated to one or more other donees. For example, the substantiation requirements apply if the taxpayer claims on his or her return for the year a deduction of $2,000 for rare books given to College *A*, $2,500 for rare books given to Museum *B*, and $900 for rare books given to Public Library *C*.

If the claimed value exceeds the specified dollar amount, the appraisal requirements apply whether or not the donated property is capital-gain property, whether the property has appreciated or depreciated in value since its acquisition by the donor, and whether the donee is a public charity, a private foundation, or other donee eligible to receive contributions that may qualify for deduction under section 170.

Deductions claimed for cash donations or for donations of property not subject to the substantiation rules of section 155(a) of the Act are subject to any substantiation requirements prescribed pursuant to present or future Treasury regulations under section 170.

Qualified appraisal

For contributions of property as to which the donor appraisal requirements apply, the donor (1) must obtain and retain a qualified written appraisal by a qualified appraiser for the property contributed, (2) must attach an appraisal summary signed by the apprais-

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[19] The term "closely held corporation" means any corporation (other than an S corporation) with respect to which the stock ownership requirement of sec. 542(a)(2) is met.

[20] The term "personal service corporation" means any corporation (other than an S corporation) that is a service organization within the meaning of sec. 414(m)(3).

[21] To meet this definition for exclusion from the appraisal and information return requirements, it is not sufficient merely that market quotations for the securities are readily available (e.g., from established brokerage firms); rather, the market quotations must be readily available on an established securities market.

er to the return on which a deduction is first claimed for such contribution, and (3) must also include on such return such additional information (including the cost basis and acquisition date of the donated property) as may be prescribed by Treasury regulations.

The appraisal must be made by an appraiser who is qualified to make appraisals of the type of property donated. To be a qualified appraisal, the appraisal cannot be made by the taxpayer, a party to the transaction in which the taxpayer acquired the property, the donee, any person employed by any of the foregoing, or any person related (within the meaning of sec. 267(b)) to any of the foregoing. Thus, for example, if an individual acquired a painting from an art dealer and later donated the painting to a museum, an appraisal by the donor, by the dealer who sold the painting, by the museum, by any person employed by the donor, the dealer, or the museum, or any person related to any of the foregoing is not a qualified appraisal.

Also, to the extent provided in Treasury regulations, an appraisal is not qualified if made by a person whose relationship to the taxpayer would cause a reasonable person to question the independence of such appraiser. For example, in appropriate circumstances, an appraisal by a person who is regularly retained by the taxpayer as an appraiser (but who is not considered an employee of the taxpayer) could be considered, pursuant to Treasury regulations, not to be a qualified appraiser for purposes of this provision where a longstanding relationship between the taxpayer and the appraiser would cause a reasonable person to question the independence of the appraiser.

An appraisal for which all or any part of the fee is based on a percentage of the appraised value of the donated property cannot constitute a qualified appraisal. However, an appraisal is not disqualified under this rule where all or a portion of the fee is based on a sliding scale if the fee is paid to any generally recognized association that regulates appraisers. This exception for certain sliding scale fees applies only if no persons have a stock, ownership, or other beneficial interest in the association.

To satisfy the definition of a qualified appraisal, the appraisal must include a description of the donated property, the fair market value of the property on the date of contribution, the specific basis for the valuation (e.g., specific information about comparable sales), the qualifications of the appraiser, and such additional information as may be required by Treasury regulations. Also, to be qualified, the appraisal must state that it is being prepared for income tax purposes, and must be signed by the appraiser, whose tax identification number must be listed. Accordingly, if the appraiser prepared such an appraisal (or appraisal summary) knowing that the appraisal overvalued the property (and hence, if used, would result in an understatement of the donor's tax liability), such appraiser would be subject to the civil tax penalty for aiding and abetting an understatement of tax liability (sec. 6701).[22]

The qualified appraisal must be received by the donor before the timely filing, including filing pursuant to any extension for filing

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[22] *See* also explanation below of Act sec. 156 (authorization for IRS to disregard appraisals of persons penalized for aiding in understatements of tax liability).

actually allowed to the donor, of the income tax return (for the year in which the contribution was made) on which the deduction is first claimed for the donated property. Thus, if the donor fails to obtain the required qualified appraisal for donated property before filing his or her return claiming a charitable deduction for such contribution, the donor cannot thereafter obtain an appraisal and attach the appraisal summary to an amended return for the year of the contribution or submit the summary to the Internal Revenue Service for attachment to the original return; accordingly, no deduction is allowed in such circumstances.

Appraisal summary

The donor must attach to such return on which the deduction is first claimed a summary of the qualified appraisal (the "appraisal summary"), with such information and in such form as prescribed by Treasury regulations. The appraisal summary must be signed by the qualified appraiser who prepared the qualified appraisal, must list the appraiser's tax identification number, and must be acknowledged by the donee of the appraised property in such manner as prescribed by Treasury regulations (see discussion below under "Information return by donee on dispositions"). As an additional condition for obtaining a deduction, the donor must retain the written qualified appraisal itself.

In addition to attaching the appraisal summary to the return claiming the deduction, the donor must include on the return statements of the cost basis and the acquisition date of the donated property, and any other information to the extent required by Treasury regulations. If there is reasonable cause why the donor does not have information on the cost basis or acquisition date, the donor instead may substitute an explanatory statement, pursuant to Treasury regulations, with the return.

Other rules

Under the Act, the Internal Revenue Service is authorized and directed to revise the individual income tax return (Form 1040) for 1985 to add a separate line for claiming deductions for donations of property as to which a qualified appraisal is required. The instructions for the return are to include instructions as to the substantiation requirements (or a reference to an Internal Revenue Service publication providing such information).

If the Internal Revenue Service, in its normal processing of returns as filed, finds that a taxpayer claimed a charitable deduction on the separate line relating to donations of property for which a qualified appraisal is required, but that the taxpayer failed to attach the required appraisal summary, then the Internal Revenue Service (to the extent administratively practicable) is to so notify the taxpayer and request the filing of the summary appraisal. If the taxpayer in fact had timely obtained a qualified appraisal of the donated property from a qualified appraiser (i.e., prior to the filing of a timely return on which the deduction is first claimed), the deduction is not to be disallowed for failure to comply with the appraisal requirement merely because the taxpayer failed to attach the required appraisal summary to the return if both (1) the taxpayer's failure was not in bad faith and also (2) the taxpayer furnishes an appraisal summary (that satisfies the requirements of the Act) to the Internal Revenue Service no later than within a reasonable period after the Internal Revenue Service gives the notice referred to in the preceding sentence.

Any failure by the Internal Revenue Service to provide such notice to the donor where a return is received on which the taxpayer has claimed a charitable deduction on the separate line relating to contributions for which a qualified appraisal is required, but where no appraisal summary is attached, does not in any way relieve the donor of the requirement, as a condition for obtaining any charitable deduction for such donations of property, of furnishing the Internal Revenue Service with the appraisal summary and of otherwise complying with the substantiation requirements, including having obtained a qualified appraisal by a qualified appraiser prior to the filing of the return.

Information return by donee on dispositions (sec. 155(b) of the Act)

The Act provides that if a donee charity sells, exchanges, transfers, or otherwise disposes of any "charitable deduction property" within two years of the date of receipt of such property, the donee must furnish an information return (in accordance with Treasury regulations and IRS forms) to the Internal Revenue Service setting forth the donor's name, address, and tax identification number, a description of the property, the date of the contribution, the amount (including the fair market value of any property), if any, received on the disposition, and the date of disposition (new Code sec. 6050L). The donee must furnish a copy of the return to the donor at such time and in such manner as prescribed by Treasury regulations. Penalties under sections 6652 and 6678, as amended by the Act, apply for failure to comply with the information return requirements.[23]

The Act defines charitable deduction property (to which the donee information return requirements apply) as any property, other than "publicly traded securities," contributed in a contribution for which a deduction was claimed under Code section 170 if the claimed value of such property exceeds $5,000 for any single item of such property or exceeds $5,000 in the aggregate for the claimed value of the property and of all similar items of such property donated during the year by the donor to one or more donees. (Unlike the appraisal rules, there is no higher dollar threshold applicable on disposition of donated stock.) The term publicly traded securities is defined by the Act as securities for which (as of the date of the contribution) market quotations are readily available on an established securities market.[24]

To facilitate the donee's compliance with these information return requirements, which are based on the amount of charitable deduction claimed on the donor's return and not on the amount received on disposition by the donee, Treasury regulations are to provide that an individual donor (as part of the donor appraisal requirements) must (1) submit the appraisal summary to the donee

[23] The Act makes a clerical amendment to the table of sections which includes new Code sec. 6050L.

[24] *See* note 21, *supra*.

for the donee's acknowledgment signature and (2) notify the donee, in the manner required by regulations, of the aggregate amount claimed for any donations of similar items made during the same year to one or more donees. (The donor need not provide each donee with the names of the other donees.) A donee's acknowledgment signature on the summary appraisal solely represents acknowledgment of receipt of the property described in the summary appraisal that was donated to that donee, and in no way is to be construed as indicating the donee's agreement with or acceptance of the valuation or amount claimed by the donor for the donated property on the appraisal summary. The regulations are to provide appropriate rules for unusual situations where the donor is unable to obtain acknowledgment by the donee.

Modifications to incorrect valuation penalty (sec. 155(c) of the Act)

Modifications of general applicability

The Act amends the prior-law incorrect valuation penalty provisions generally (i.e., for all incorrect valuations made subject to penalty) by deleting the prior-law exception for property held for more than five years, and by extending the penalty to incorrect valuations for estate and gift tax purposes.[25]

New Code section 6660[26] applies as follows in the case of any underpayment of subtitle B (estate and gift) taxes attributable to a valuation understatement—

(1) If the claimed value is two-thirds or less but not less than 50 percent of the correct amount, an addition to tax is imposed equal to 10 percent of the tax underpayment attributable to the undervaluation.

(2) If the claimed value is 40 percent or more but less than 50 percent of the correct amount, an addition to tax is imposed equal to 20 percent of the tax underpayment attributable to the undervaluation.

(3) If the value claimed is less than 40 percent of the correct amount, an addition to tax is imposed equal to 30 percent of the tax underpayment attributable to the undervaluation.

No penalty applies under section 6660 if the underpayment is less than $1,000 for any taxable period (or, in case of the estate tax, with respect to the estate of the decedent). The Internal Revenue Service has discretionary authority to waive all or any part of the addition to tax pursuant to section 6660 if the taxpayer establishes that there was a reasonable basis for the valuation claimed on the return and that such claim was made in good faith.

Modifications of limited applicability

In addition, the Act made two modifications to the section 6659 penalty provisions that apply only in the case of an underpayment attributable to a valuation overstatement with respect to charitable deduction property. For this purpose, charitable deduction property generally means any property contributed by the taxpayer in

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[25] For related provisions, *see* description below of Act sec. 158 (interest on certain additions to tax).

[26] The Act makes a clerical amendment to the table of sections for subchapter A of chapter 68 to reflect new Code sec. 6660.

a contribution for which an income tax deduction was claimed under section 170. However, for purposes solely of the waiver authority provision, charitable deduction property does not include any securities for which (as of the date of contribution) market quotations are readily available on an established securities market.[27]

Under the first additional modification, the section 6659 penalty is increased to a flat 30 percent of the tax liability underpayment where the claimed valuation is 150 percent or more of the correct amount.

Under the second additional modification, the Internal Revenue Service may not waive any portion of the section 6659 penalty unless (1) the taxpayer shows (as required under the general section 6659 waiver provision) that there was a reasonable basis for the claimed valuation and that the claim was made in good faith, and (2) the Internal Revenue Service determines both that the claimed value of the property was based on a qualified appraisal made by a qualified appraiser[28] and that, in addition to obtaining such appraisal, the taxpayer made a good faith investigation of the value of the contributed property.

Effective Date

The donor appraisal and donee information return requirements apply to charitable contributions made after December 31, 1984. The incorrect valuation provisions apply to returns filed after December 31, 1984 (including such returns on which deductions are claimed for contributions made prior to 1985).

b. Authorization to disregard appraisals of persons penalized for aiding in understatements of tax liability (sec. 156 of the Act and sec. 330 of title 31, United States Code) [29]

Prior Law

Under prior and present law, the Secretary of the Treasury may prescribe rules governing the admission of lawyers and accountants to practice before the Internal Revenue Service and may bar individuals from practice if he finds them to be incompetent, disreputable, or grossly negligent. Prior law did not provide any comparable authority with respect to the appearance of professional appraisers in proceedings before the Internal Revenue Service.

Reasons for Change

Congress believed that professional appraisers who seek to present evidence to the Internal Revenue Service should be subject to the same type of professional regulation that applies to attor-

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[27] See note 21, *supra*.

[28] The terms qualified appraisal and qualified appraiser have the same meaning as under the substantiation requirements set forth in Treasury regulations prescribed pursuant to sec. 155(a) of the Act.

[29] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 156; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), p. 1361; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 151; S. Prt. 98-169, Vol. I (April 2, 1984), p. 438; and H. Rep. No. 98-861 (June 23, 1984), p. 999 (Conference Report).

neys and accountants practicing before the Internal Revenue Service and to attorneys appearing in court proceedings.

Explanation of Provision

The Secretary of the Treasury is authorized to bar from appearing before the Internal Revenue Service or the Treasury Department, for the purpose of offering opinion evidence on the value of property or other assets, any individual against whom a civil penalty for aiding and abetting the understatement of tax (sec. 6701) has been assessed. Thus, an appraiser who aids or assists in the preparation or presentation of an appraisal in connection with the tax laws will be subject to disciplinary action if the appraiser knows that the appraisal will be used in connection with the tax laws and will result in an understatement of the tax liability of another person. The Secretary is also given authority to provide that the appraisals of an appraiser who has been disciplined have no probative effect in any administrative proceeding before the Department of the Treasury or the Internal Revenue Service.

Effective Date

The provision applies to appraisers with respect to whom penalties for aiding and abetting the understatement of tax are assessed under section 6701 after July 18, 1984.

c. Mailing of deposits of taxes (sec. 157 of the Act and sec. 7502 of the Code) [30]

Prior Law

Under prior and present law, deposits of taxes are required to be made in any designated financial institution (such as a bank). Deposits must be made as frequently as 8 times per month, depending on the amount required to be deposited. Interest and penalties may be imposed if a deposit is not made by the due date. Under prior law, any deposit could be treated as timely made if it was mailed as required 2 days prior to the due date.

Reasons for Change

Some corporations were abusing the timely mailing rule by using certified or registered mail to deposit taxes with distant financial institutions, thereby retaining the use of the funds until after the due date. The mailing of deposits to remote depositories by certified or registered mail could result in delays in depositing of up to 2 weeks. Consequently, the funds were not deposited by the appropriate date and the funds were unavailable to the Treasury. The depositor retained use of the funds until the deposit was delivered.

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[30] For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 160; S. Prt. 98-169, Vol. I (April 2, 1984), p. 454; and H. Rep. No. 98-861 (June 23, 1984), p. 1000 (Conference Report).

Explanation of Provision

Any person required under Treasury regulations promulgated under section 6302(c) to deposit any tax more than once a month must deposit by the due date, regardless of the method of delivery, all deposits of $20,000 or more that are required to be made under any Treasury regulations promulgated under that section. Only businesses and other entities making large deposits are generally required to deposit any single type of tax more than once a month. Consequently, many small businesses, as well as many governmental units, are exempt from this new provision.

Examples of taxes the deposit of which is provided for in Treasury regulations promulgated under section 6302(c) include the following:

(1) withheld income taxes and social security (FICA) taxes (see Treas. Reg. sec. 31.6302(c)-1);

(2) employee and employer railroad retirement taxes (see Treas. Reg. sec. 31.6302(c)-2);

(3) FUTA taxes (see Treas. Reg. sec. 31.6302(c)-3);

(4) corporate income and estimated taxes (see Treas. Reg. sec. 1.6302-1 and 1.6154-4);

(5) excise taxes reported on Form 720 (see Treas. Reg. secs. 48.6302(c)-1 and 49.6302(c)-1);

(6) taxes withheld from nonresident aliens and foreign corporations (see Treas. Reg. sec. 1.6302-2); and

(7) taxes withheld in accordance with backup withholding (see Treas. Reg. sec. 35a.9999-1 (question and answer 47)).

Example

Assume a corporation is required to deposit withheld income taxes and social security taxes eight times a month (as provided in Treas. Reg. sec. 31.6302(c)-1(a)(1)(i)(*b*)). Each of those deposits that is $20,000 or more must be made by the due date, regardless of the method of delivery. In addition, any other deposit that the corporation makes under section 6302 that is $20,000 or more must be made by the due date, regardless of the method of delivery. This is true even if that deposit is made on a schedule requiring that deposits be made once a month or less frequently.

Effective Date

The provision became effective for deposits required to be made after July 31, 1984.

d. Interest on certain additions to tax (sec. 158 of the Act and sec. 6601 of the Code) [31]

Prior Law

Under prior and present law, a taxpayer who fails to file a tax return by the date required (unless the failure is due to reasonable

[31] For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 158; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 451-452; and H. Rep. No. 98-861 (June 23, 1984), p. 1000 (Conference Report).

cause and not to willful neglect) is subject to an addition to tax of 5 percent of the amount of tax due for the first month of the failure to file, and 5 additional percent for each additional month, up to a maximum of 25 percent (sec. 6651). A taxpayer who files a tax return on which there is a valuation overstatement is subject to an addition to tax of from 10 to 30 percent (depending on the amount of overstatement) of the understatement of tax attributable to the valuation overstatement (sec. 6659). A taxpayer who files a tax return on which there is a substantial understatement of tax is subject to an addition to tax of 10 percent of the amount of the underpayment attributable to the understatement (sec. 6661).

Under prior and present law, interest on penalties and additions to tax is generally imposed only for the period from the date of notice and demand to the date of payment. An interest-like element is added to the negligence and fraud penalties for the period from the last day prescribed for payment of the tax to the date of assessment (or payment, if earlier). Under prior law, no comparable element is added to the failure to file, gross valuation overstatement, and substantial understatement penalties.

Reasons for Change

Congress believed that the strength of the failure to file, valuation overstatement, and substantial understatement penalties should not be diluted by delays, which may be substantial when a taxpayer purposefully resorts to every available administrative and judicial process to avoid resolution of a case. An interest element running from the due date of the return was added to these penalties to increase their efficacy. Specifically, Congress believed that a taxpayer who delays resolution of his case should not be subject to a lighter penalty (by reason of the time value of money) than a taxpayer who settles his case promptly.

Explanation of Provision

Interest (at the rate prescribed in section 6621) is imposed on the amount of the following additions to tax from the due date of the return (including any extensions granted) until the date that the additions to tax are paid:

(1) failure to file (sec. 6651(a)(1));

(2) gross valuation overstatement (sec. 6659);

(3) valuation understatement for purposes of the estate or gift taxes (sec. 6660); and

(4) substantial understatement (sec. 6661).

Effective Date

The provision became effective for interest accrued after the date of enactment, except with respect to additions to tax for which notice and demand is made before the date of enactment.

e. Penalty for fraudulent withholding exemption certificate or failure to supply information (sec. 159 of the Act and sec. 7205 of the Code) [32]

Prior Law

Under prior and present law, an individual who supplies false or fraudulent withholding information (such as on an employee's withholding allowance certificate (Form W-4) or in connection with backup withholding) or willfully fails to supply information is subject to a criminal penalty. Under prior law, this penalty was in lieu of any other penalty (except a civil fine).

Reasons for Change

Congress was concerned that the language providing that this false withholding allowance certificate penalty is in lieu of any other penalty might be read to provide that an individual who willfully attempts to evade tax and who also files a false W-4 would only be subject to a criminal penalty for filing a false Form W-4 and not to the willful attempt to evade tax penalty under section 7201. Congress believed that the criminal penalty under section 7205 should not be exclusive.

Explanation of Provision

The Act provides that the criminal penalty for supplying false or fraudulent withholding information or willfully failing to supply information is in addition to any other penalty. Thus, for example, prosecution for willful evasion (sec. 7201) is not barred where prosecution for a false certificate (sec. 7205) is also possible.

No inference should be drawn with respect to the correct interpretation of prior law on this issue; however, to the extent that *United States v. Williams*, 644 F. 2d 696 (8th Cir., 1981)) might be considered authority to the contrary, the rationale of that decision no longer applies.

Effective Date

The provision became effective for acts and failures to act occurring after the date of enactment.

f. Penalty for frivolous proceedings before the Tax Court (sec. 160 of the Act and sec. 292 of the Tax Equity and Fiscal Responsibility Act of 1982) [33]

Prior Law

Prior to the enactment of TEFRA, the Tax Court had discretionary authority to award damages of up to $500 for proceedings insti-

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[32] For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 159; S. Prt. 98-169, Vol. I (April 2, 1984), p. 453; and H. Rep. No. 98-861 (June 23, 1984), p. 1001 (Conference Report).

[33] For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 161; S. Prt. 98-169, Vol. I (April 2, 1984), p. 455; and H. Rep. No. 98-861 (June 23, 1984), p. 1001 (Conference Report).

tuted merely for delay. TEFRA raised the maximum to $5,000 and expanded the basis of the award to include proceedings maintained for delay. These changes were not effective for cases pending in the Tax Court at the time of TEFRA's enactment.

Reasons for Change

Congress believed that the Tax Court should have discretionary authority to award the increased amount of damages in any currently docketed case, not only actions and proceedings commenced after December 31, 1982. This is consistent with the TEFRA amendment in that damages can be awarded not only where actions are "instituted," but also where they are "maintained" for delay.

Explanation of Provision

The Act provides that expanded damages can also be awarded against taxpayers with proceedings pending before the Tax Court as of 120 days after the date of enactment, regardless of when instituted. This 120-day period provided taxpayers who maintained proceedings before the Tax Court at the time of the enactment of this Act potentially subject to damages under section 6673 because of this amendment to withdraw or settle those proceedings before the awarding of the increased maximum amount of damages could occur.

Effective Date

The provision became effective with respect to taxpayers with proceedings pending before the Tax Court 120 days after July 18, 1984.

g. Failure to request change of method of accounting (sec. 161 of the Act and sec. 446 of the Code) [34]

Prior Law

Under prior and present law, a taxpayer is not permitted to change its accounting method without the consent of the Secretary. Previously, some taxpayers using an improper method argued there was no requirement to request permission to change from an improper to a proper method. They asserted the failure of the Secretary to consent to a change in method (because it had not been requested) as a defense to any penalty arising from use of the improper method.

Reasons for Change

Congress believed that the interpretation placed on prior law by taxpayers with improper methods of accounting might have created an unintended protection against penalties for taxpayers.

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[34] For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 157; S. Prt. 98-169, Vol. I (April 2, 1984), p. 450; and H. Rep. No. 98-861 (June 23, 1984), p. 1002 (Conference Report).

Explanation of Provision

The Act provides that if the taxpayer does not request a change in accounting method, the absence of the Secretary's consent cannot be asserted as a defense to the imposition of any penalty or addition to tax or to diminish the amount of any penalty or addition to tax. No inference should be drawn with respect to the validity of the defense asserted by some taxpayers under prior law.

Congress believed that the Internal Revenue Service's general practice is not to assert a penalty for use of an improper method of accounting for the year that includes the date of enactment of this Act against a taxpayer who has not been notified that its return is going to be examined and who wishes to change from an improper method of accounting to a proper method for that taxable year, but is precluded from doing so because the deadline for requesting a change in accounting method for that taxable year has passed, if the taxpayer files a request for permission to change methods as soon as practicable, but in no event later than the due date (with extensions) of the taxpayer's return for that taxable year. The Service may, however, treat this type of application as a request for a change in accounting method for the next year and decline to permit the change to be effective for the year the application is filed.

Effective Date

The provision became effective for taxable years beginning after July 18, 1984. Congress intended that no inference be drawn with respect to the validity of the defense asserted by some taxpayers under prior law.

h. Clarification of change of venue for certain tax offenses (sec. 162 of the Act and sec. 3237 of title 18, United States Code) [35]

Prior Law

The general venue provision for the prosecution of Federal offenses committed in more than one district is 18 U.S.C. 3237(a). Except as otherwise provided by law, a Federal offense may be prosecuted in any judicial district where the offense was begun, continued, or completed. An offense involving use of the mails, or transportation in interstate or foreign commerce, is a continuing offense which may be prosecuted in any judicial district from, through, or into which the mail or commerce moves.

Section 3237(b) modifies the general venue provisions of section 3237(a) in cases where a prosecution is instituted for violation of certain specific tax statutes (26 U.S.C. 7201 and 7206(1), (2), or (5)), the offense involves use of the mails, and the prosecution is commenced in a district other than the district in which the defendant resides. Modification of the general venue provision is also provided for prosecutions under 26 U.S.C. 7203. In such cases, the defendant

[35] For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 165; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 458-459; Senate floor amendment, 130 Cong. Rec. S.4121, 4123 (April 9, 1984); and H. Rep. No. 98-861 (June 23, 1984), pp. 1002-1003 (Conference Report).

may file a motion within 20 days after arraignment electing to be tried in the district in which he was residing at the time the alleged offense was committed. The Courts of Appeal for the Second Circuit (*in re United States (Clemente)*, 608 F.2d 76 (2d Cir. 1979), cert. denied, 446 U.S. 908 (1980)) and the Fourth Circuit (*in re Petition of the United States (Nardone)*, 706 F.2d 494 (4th Cir. 1983)) have held that the transfer of venue election is available only when venue in the district of prosecution is dependent on the use of the mails. The Court of Appeals for the Ninth Circuit (*United States* v. *United States District Court (Solomon)*, 693 F.2d 68 (9th Cir. 1982)) and several district courts have held, on the other hand, that when the mails are used as part of the offense, the election to transfer the prosecution is available even though venue is not based on the mailing.

Reasons for Change

Congress believed that the transfer of venue option should provide a defendant with a shield against having to defend a tax prosecution far from his residence where the place of prosecution is based solely on a mailing to a distant office of the Internal Revenue Service. The option should not be available to permit transfer on the election of the defendant in cases in which the prosecutor seeks to establish venue wholly apart from the receipt by the Internal Revenue Service of materials transmitted by mail.

Explanation of Provision

The Act provides that transfer of venue is required only when the sole basis for venue in a particular district is receipt by the Internal Revenue Service of mailed materials. Thus, defendants will not be able to force transfer of venue to an inconvenient forum solely because the mails were used as part of the alleged offense. The Internal Revenue Service and the Department of Justice generally attempt to establish venue for a criminal tax prosecution in the judicial district of the taxpayer's residence or principal place of business, because prosecution in that judicial district usually has the most significant deterrent effect. Congress did not intend a change in that general policy. The Internal Revenue Service and the Justice Department may, however, have valid reasons for bringing a prosecution in another district. Examples of this are multiple defendant cases or cases in which venue for non-tax charges is established in a district other than the place of residence or business. Congress did not intend to restrict the Service and the Department in instances such as these.

Effective Date

The provision became effective on July 18, 1984.

i. Statute of limitations relating to contributions to the capital of a corporation (sec. 163 of the Act and sec. 118 of the Code) [36]

Prior Law

Under prior and present law, a contribution in aid of construction to a regulated public utility that is not included in the utility's rate base, and that is expended before the end of the second taxable year following the year of receipt, is not included in the utility's gross income. If it is not expended by the end of the second year, it is includible in the utility's income in the year of receipt. Under prior law, the statute of limitations was 3 years (absent fraud) from the filing of the return.

Reasons for Change

The proper tax treatment of a contribution of capital to a regulated public utility cannot be verified until the close of the expenditure year. By the time the Internal Revenue Service examines the return of tax for the expenditure year, the statute of limitations generally may have expired for the year of receipt. Consequently, if the taxpayer did not include in gross income in the year of receipt an amount that the taxpayer anticipated expending but that was not, in fact, expended by the close of the expenditure year, the Internal Revenue Service may not be able to assess and collect the deficiency because the statute of limitations for the year of receipt may have expired.

Explanation of Provision

The Act provides that the statute of limitations for the assessment of any deficiency (and any ancillary adjustments) attributable to any contribution to the capital of a corporation does not expire before the expiration of 3 years from the date the Secretary is notified by the taxpayer that the contribution has been expended in the required manner, that the taxpayer intends not to make the required expenditure, or that the taxpayer has failed to make the required expenditure. This provision is similar to the rule that applies in the case of rollovers of gain on the sale of a principal residence (sec. 1034(j)).

Effective Date

The provision is effective with respect to expenditures with respect to which the second taxable year following the year of receipt ends after December 31, 1984.

[36] For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 842; S. Prt. 98-169, Vol. I (April 2, 1984), p. 797; and H. Rep. No. 98-861 (June 23, 1984), pp. 1003-1004 (Conference Report).

4. Revenue Effect of Compliance Provisions

The provisions relating to tax shelters are estimated to increase fiscal year budget receipts by $26 million in 1985, $30 million in 1986, $28 million in 1987, $24 million in 1988, and $20 million in 1989.

The information reporting provisions are estimated to increase fiscal year budget receipts by $20 million in 1985, $92 million in 1986, $175 million in 1987, $232 million in 1988, and $255 million in 1989.

The other compliance provisions are estimated to increase fiscal year budget receipts by $11 million in 1985, $48 million in 1986, $53 million in 1987, $56 million in 1988, and $58 million in 1989.

All the compliance provisions considered together are estimated to increase fiscal year budget receipts by $57 million in 1985, $170 million in 1986, $256 million in 1987, $312 million in 1988, and $333 million in 1989.

L. Miscellaneous Tax Reform Provisions

1. Inclusion of Tax Benefit Items in Income (sec. 171 of the Act and sec. 111 of the Code)[1]

Prior Law

Under the judicially created tax benefit rule, a taxpayer who recovers an item for which a deduction was claimed in a prior tax year generally must recognize income if the deduction resulted in a reduction in taxes in the earlier year. The taxpayer includes in income in the year of recovery an amount equal to the portion of the deduction that produced a tax benefit in the prior year, and excludes from income an amount equal to the portion that did not produce a tax benefit. The rationale of the tax benefit rule is that the taxpayer should be put in approximately the same after-tax position as if only the correct amount had been deducted.

Under prior law, the tax benefit rule was codified as to recoveries of bad debts, taxes, and delinquency amounts previously deducted (sec. 111). If a previously deducted amount was recovered, section 111 permitted a "recovery exclusion" from gross income for an amount equal to the portion of the deduction in the prior year that did not reduce taxes.

Section 111, as amplified by Treasury regulations, had the effect of allowing an individual taxpayer to recover, on a tax-free basis, State taxes and other items deducted as itemized deductions in a prior year up to the amount by which the zero bracket amount exceeded the taxpayer's other itemized deductions for that year.[2] For example, assume that for 1983, a married couple filing a joint return had $3,700 in itemized deductions, of which $500 related to State income taxes withheld during 1983, and that in 1984, they receive a tax refund from the State in the amount of $200. Under prior law, the entire $200 would be regarded as a recovery exclusion and would be excluded from gross income.[3]

Reasons for Change

Congress believed that the treatment accorded under section 111 of prior law to State income tax refunds, and to other itemized deductions subject to the zero bracket amount or a similar statutory

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[1] For legislative background of the provision, *see*: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 161; H.R. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1368-1369; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 175; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 472-473; and H.R. Rep. No. 98-861 (June 23, 1984), p. 1011 (Conference Report).

[2] The legislative history of the statutory predecessor of section 111 supported this interpretation. *See* H.R. Rep. No. 2333, 77th Cong., 2d Sess. 70 (1942); S. Rep. No. 1631, 77th Cong., 2d Sess. 80 (1942).

[3] *See* Rev. Rul. 79-15, 1979-1 C.B. 80, for examples of the application of section 111 to State tax refunds.

floor, failed to reflect economic reality in certain circumstances. This resulted from the assumption that a taxpayer first recovered the portion (if any) of the amount deducted in the prior year that did not reduce taxable income[4] and, hence, did not produce a tax benefit. Congress believed that the assumption that the first dollars recovered were not those which produced a tax benefit was, in certain cases, erroneous and created a windfall to the taxpayer.

Thus, in the example set forth above, the taxpayers were allowed to claim excess itemized deductions (deductions in excess of the zero bracket amount) of $300 in 1983, reducing their taxable income by that amount. Had the taxpayers deducted only those taxes which they actually owed to the State, they would have claimed only $100 in excess itemized deductions ($3,200 other itemized deductions, plus $300 State taxes, less the $3,400 zero bracket amount). By allowing the taxpayers to recover $200 without tax consequences, prior law failed to achieve the tax benefit rule's objective of putting taxpayers in roughly the same position as if the "erroneous" deduction had never been taken.

Accordingly, Congress concluded that the law should be amended to reflect more accurately the tax benefit concept.

Explanation of Provision

The Act amends section 111 to provide that if an amount attributable to a deduction claimed in a prior year is recovered, such amount is excludable from gross income only to the extent it did not reduce income subject to tax. Thus, in the example set forth above, the $200 recovered in 1984 would be included in gross income in that year.

The Act also provides that if a credit was allowable for a taxable year with respect to certain property and, in a subsequent taxable year, there is a downward adjustment of the price of the property (or other amount on which the credit was based), the tax liability of the taxpayer for the year of recovery is increased by the amount of the credit attributable to the adjustment (but only if, and to the extent that, the credit attributable to the recovered amount reduced the taxpayer's tax in the prior year). This credit recapture provision does not apply to investment tax credits allowed under section 46 or to foreign tax credits allowed under sections 901, 902, or 903, which are subject to specific rules under existing law.

As under prior law, an increase in a deduction carryover that has not expired before the beginning of the taxable year of recovery is treated as having reduced income subject to tax. A parallel rule is provided for credit carryovers.

No change is made to the rules of prior law relating to what constitutes the recovery of an item previously deducted, and no inference is to be drawn from these amendments as to the scope of those rules under prior law.

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[4] The portion that did not reduce taxable income was the excess of the zero bracket amount over the taxpayer's other itemized deductions.

Effective Date

The provision applies to amounts recovered after December 31, 1983, in taxable years ending after that date.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $229 million in 1985, $253 million in 1986, $274 million in 1987, $300 million in 1988, and $330 million in 1989.

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2. Below-market and Interest-free Loans (sec. 172 of the Act and new sec. 7872 of the Code)[5]

Prior Law

Transfers of income other than by interest-free or below-market interest rate loans

Direct assignments of income.—Investment income is generally taxed to the owner of the income producing property, even if the owner of the property makes a gift of the right to receive the income prior to its receipt. The rationale for this rule is that the owner of the property realizes the income upon the exercise of control over its disposition. *Helvering v. Horst*, 311 U.S. 112 (1940). Further, an assignment of the right to receive income is a taxable gift by the assignor to the assignee which occurs at the time of the assignment. In such case, the amount of the gift is the value of the right received by the donee.

For example, if a cash method taxpayer detaches coupons from a bond and gives them to his or her son, without receiving fair value in exchange, and the son receives the interest represented by the coupons, the interest income would be included in income by the parent donor under the principles of Horst. In addition, the donor would be treated for gift tax purposes as having made a gift to the son in an amount equal to the value of the interest income to be received by the son.

Transfers of income-producing property to trusts.—In general, the income of a trust that is distributed by the trust to its beneficiaries is not taxed at the trust level. Rather, such income is taxed only to beneficiaries of the trust. In contrast, income retained by a trust is taxed to the trust. If, however, a transferor of property to a trust (a "grantor") is treated as the owner of the transferred property for Federal income tax purposes, income, deductions and credits of the trust are attributed directly to the grantor and not to either the trust or its beneficiaries.

In general, a grantor is treated as the owner of transferred property if he retains certain power over, or interest in, the trust. Under section 676, a grantor is treated as the owner of a revocable trust. In addition, under section 673(a) a grantor is treated as the owner of all or a portion of a trust in which he has a reversionary interest in either corpus or income if, as of the inception of that portion of the trust, the grantor's interest will, or may reasonably be expected, to take effect in possession or enjoyment within 10

[5] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 162; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1370; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 176; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 474; and H. Rep. No. 98-861 (June 23, 1984), pp. 1011 (Conference Report).

years commencing with the date of the transfer of that portion of the trust. For example, if a grantor were to transfer $50,000 to a trust, and the trust agreement were to provide that (1) the income would be distributed annually to the grantor's son, (2) the trust would terminate after eight years, and (3) at termination, the trust corpus would be returned to the grantor, the grantor would be treated as the owner of the trust and the income generated by it would be taxed to the grantor.

For gift tax purposes, a transfer of property to a trust is a taxable gift from the grantor of the trust to the trust's beneficiaries in an amount equal to the value of the beneficiaries' interests in the transferred property after the transfer. A transfer to a trust results in a taxable gift to the extent of the value of the beneficiaries' interest regardless of whether the grantor is treated as the owner of part or all of the trust under the grantor trust rules. In the example set forth above, the grantor would be treated as having made a taxable gift to his or her son in an amount equal to the value, determined at the time of the transfer to the trust, of the right to the use of $50,000 for a period of eight years.

Demand or term loans to family members

Under prior law, an interest-free or below-market interest rate loan (each of which is referred to herein as a "below-market loan") without consideration resulted in a gift from the lender to the borrower for Federal tax purposes. *Dickman v. Commissioner*, 465 U.S. ——— (1984), 52 U.S.L.W. 4222 (U.S. Feb. 22, 1984). In the case of a demand loan, the amount of the gift was the value of the right to the use of the money for "such portion of the year as the [lender] in fact allows the [borrower] the use of the money." Rev. Rul. 73-61, 1973-2 C.B. 408. Under this approach, the amount of the gift was calculable as of the last day of each calendar year during which the loan was outstanding.[6]

In the case of a term loan, the amount of the gift was the excess, at the time of the exchange of the money and the note, of the amount of money borrowed over the present value of the principal and interest payments required to be made under the terms of the loan. See Rev. Rul. 73-61, supra; Rev. Rul. 81-286, 81-2 C.B. 176; *Blackburn v. Commissioner*, 20 T.C. 204 (1953); *Mason v. United States*, 365 F.Supp. 670, aff'd 513 F.2d 25 (1975); and *Dickman v. United States, supra*.

Under prior law, the Federal income tax consequences of these below-market loans were not clear. Prior to enactment of the provision, the courts had addressed only the gift tax consequences of the transactions.

Loans to employees or shareholders

Demand loans.—Under prior law, the Internal Revenue Service consistently asserted that, in the case of a below-market demand loan to an employee or shareholder (other than a loan to which sec-

[6] In *Dickman*, the Supreme Court did not reach the question of the valuation of the gift. In dicta, however, the Court stated that "to support a gift tax. . . . the Commissioner need not establish that the funds lent did in fact produce a particular amount of revenue; it is sufficient for the Commissioner to establish that a certain yield could readily be secured and that the reasonable value of the use of the funds can be reliably ascertained." 52 U.S.L.W. 4222, at 4226.

tion 482 applied), the borrower derived an economic benefit that should be included in income for Federal income tax purposes. Under the Service's position, the amount of the income was the excess of the interest that would have been charged by an independent lender over the interest, if any, that was actually charged under the terms of the loan.

Notwithstanding the Internal Revenue Service's position, the Tax Court consistently held that non-family below-market demand loans did not result in taxable income. In *J. Simpson Dean v. Commissioner*, 35 T.C. 1083 (1961), for example, the controlling shareholders of Nemours Corporation borrowed substantial sums of money from the corporation on a non-interest bearing basis. The Internal Revenue Service sought to impute interest income to the borrowers. The Tax Court, however, held that the transactions did not result in income to the borrowers on the grounds that had they "borrowed the funds in question on interest bearing notes, their payment of interest would have been fully deductible by them under section 163."[7] See also, *Beaton v. Commissioner*, 664 F.2d 315 (1st Cir. 1981); *Martin v. Commissioner*, 649 F.2d 1133 (5th Cir. 1981); *Suttle v. Commissioner*, 625 F.2d 1127 (4th Cir. 1980); *Baker v. Commissioner*, 75 T.C. 166, aff'd 677 F.2d 11 (2nd Cir. 1982); *Creel v. Commissioner*, 72 T.C. 1173 (1979); *Zager v. Commissioner*, 72 T.C. 1009 (1979); and *Hardee v. United States*, 708 F.2d 661 (Fed. Cir. 1983).

Term loans.—Under prior law, the Federal tax treatment of non-family below-market term loans was unclear. In one case, the Tax Court held that shareholders of a corporation, who obtained an interest-free loan from the corporation in order to purchase the corporation's assets, received a distribution of earnings taxable to them as a dividend. Further, the Court held that the amount of the dividend was the excess of the fair market value of the property received over the present value of the taxpayer's note. *Boyd v. Commissioner*, 5 TCM (CCH) 791 (1946). But see *Greenspun v. Commissioner*, 72 T.C. 931, aff'd 670 F.2d 123 (9th Cir. 1982).

Loans between commonly controlled corporations

Section 482 provides that, in the case of two or more organizations, trades, or businesses (whether or not incorporated, organized in the United States, or affiliated) owned or controlled directly or indirectly by the same interests, the Treasury may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades, or business. Treasury regulations under that section provide that where one member of a group of controlled entities makes a loan or advance directly or indirectly to, or otherwise becomes a creditor of, another member of such group, and charges no interest, or charges interest at a rate which is not

[7] The Tax Court distinguished this case from the cases involving rent-free use of corporate property by shareholders or officers (c.f., *Alex Silverman v. Commissioner*, 28 T.C. 1061, aff'd 253 F.2d 849 (8th Cir. 1958)) on the grounds that rental payments would not have been deductible in those cases.

equal to an arm's-length rate, appropriate allocations may be made to reflect an arm's-length interest rate for the use of the money. The term "arm's-length interest rate" is defined as the rate which was charged, or would have been charged at the time the indebtedness arose, in independent transactions, with or between unrelated parties under similar circumstances. A safe-haven is provided for qualifying loans by a creditor not regularly engaged in the business of making loans or advances of the same type to unrelated parties. Treas. Reg. sec. 1.482-2.

Loans in connection with sale or exchange of property

Under prior law, if a contract for the sale or exchange of property provided for deferred payments of part or all of the purchase price, and the deferred payments included unstated interest, section 483 required that a portion of each deferred payment be treated as interest. Deferred payments included unstated interest if the total of the deferred payments exceeded the sum of the present values of such payments plus the present values of any stated interest due under the terms of the contract. Generally, section 483 applied to payments under a contract for the sale or exchange of property made more than six months after the date of the sale or exchange, if at least one payment was due more than one year after the date of the sale or exchange. Section 483 did not apply to contracts with a sales price of $3,000 or less, certain sales or exchanges of patents, and sales or exchanges that resulted only in ordinary income to the seller.

Reasons for Change

A below-market loan is the economic equivalent of a loan bearing a market rate of interest, and a payment by the lender to the borrower to fund the payment of interest by the borrower. The Congress believed that, in many instances, the failure of the tax laws to treat these transactions in accordance with their economic substance provided taxpayers with opportunities to circumvent well-established tax rules.

Under prior law, loans between family members (and other similar loans) were being used to avoid the assignment of income rules and the grantor trust rules. A below-market loan to a family member, for example, generally involves a gratuitous transfer of the right to use the proceeds of the borrowing until repayment is demanded (in the case of a demand loan) or until the end of the term of the loan (in the case of a term loan). If the lender had assigned the income from the proceeds to the borrower instead of lending the proceeds to the borrower, the assignment of income doctrine would have taxed the lender (and not the borrower) on the income. If the lender had transferred the principal amount to a trust established for the benefit of the borrower that was revocable at will (similar to a demand loan), or that would terminate at the end of a period of not more than 10 years (similar to a term loan with a term of not more than 10 years), the income earned on trust assets would have been taxed to the lender under the grantor trust provisions set forth in Code secs. 671-679.

In addition, loans from corporations to shareholders were being used to avoid rules requiring the taxation of corporate income at the corporate level. A below-market loan from a corporation to a shareholder is the economic equivalent of a loan by the corporation to the shareholder requiring the payment of interest at a market rate, and a distribution by the corporation to the shareholder with respect to its stock equal to the amount of interest required to be paid under the terms of the loan. If a transaction were structured as a distribution and a loan, the borrower would have dividend income and an offsetting interest deduction. The lender would have interest income. Under prior law, if the transaction was structured as a below-market loan, the lender avoided including in income the interest that would have been paid by the borrower. As a result, the lender was in the same economic position as it would have been if it had deducted amounts distributed as dividends to shareholders.

Finally, loans to persons providing services were being used to avoid rules requiring the payment of employment taxes and rules restricting the deductibility of interest in certain situations by the person providing the services. A below-market loan to a person providing services is the economic equivalent of a loan requiring the payment of interest at a market rate, and a payment in the nature of compensation equal to the amount of interest required to be paid under the terms of the loan. Under prior law, a transaction structured as a loan and a payment in the nature of compensation often did not result in any tax consequences for either the lender or the borrower because each would have offsetting income and deductions. However, there were a number of situations in which the payment of compensation and a loan requiring the payment of interest at a market rate did not offset. For example, if a taxpayer used the proceeds of an arm's-length loan to invest in tax-exempt obligations, the deduction for interest paid on the loan would be disallowed under section 265. Similarly, if a term loan extended beyond the taxable year in which it was made, income and deductions did not offset because the compensation income was includible in the year the loan was made. In such circumstances, substantial tax advantages could have been derived by structuring the transaction as a below-market loan.

Explanation of Provision

Overview

The Act adds to the Code new section 7872 (relating to the tax treatment of loans that, in substance, result in a gift, payment of compensation, dividend, capital contribution, or other similar payment from the lender to the borrower). Loans that are subject to the provision and that do not require payment of interest, or require payment at a rate below the statutory rate (referred to as the "applicable Federal rate"), are recharacterized as an arm's-length transaction in which the lender made a loan to the borrower in exchange for a note requiring the payment of interest at the applicable Federal rate. This rule results in the parties being treated as if:

(1) The borrower paid interest to the lender that may be deductible to the borrower and is included in income by the lender; and

(2) The lender (a) made a gift subject to the gift tax (in the case of a gratuitous transaction), or (b) paid a dividend or made a capital contribution (in the case of a loan between a corporation and a shareholder), or (c) paid compensation (in the case of a loan to a person providing services), or (d) made some other payment characterized in accordance with the substance of the transaction.

The Congress intended that, in general, in the case of a loan subject to this provision, the amount of the deemed payment from the lender to the borrower is to be determined solely under this provision. Thus, in the case of a below-market loan from a parent to a child, the amount of the gift is to be determined under section 7872, and not under the decision in the *Dickman* case, *supra*, even if the applicable Federal rate is less than a fair market interest rate. Further, in the case of a loan from an employer to an employee, the amount of the compensation is to be determined under section 7872, and not under section 83, even if the applicable Federal rate is less than a fair market interest rate.

Payments deemed made under this provision are, in general, treated as actually made for all purposes of the Code. However, the Congress did not intend to override the rule in 4941(d)(2)(B) exempting a below-market loan to a private foundation from a disqualified person from the definition of self-dealing in section 4941(d). A technical amendment may be required to effectuate this intent.

Loans subject to the provision

The provision applies to term or demand loans that are gift loans, compensation-related loans, corporation-shareholder loans, and tax avoidance loans. In addition, the Congress intended that, under regulations to be prescribed by the Treasury, the provision is to apply to other similar transactions (i.e., loan transactions that in substance affect a transfer from the lender to the borrower other than the transfer of the principal amount of the loan) if the interest arrangements have a significant effect on the tax liability of either the borrower or the lender.

Generally, it was intended that the term "loan" be interpreted broadly in light of the purposes of the provision. Thus, any transfer of money that provides the transferor with a right to repayment is a loan. For example, advances and deposits of all kinds are treated as loans.

Demand loans and term loans.—A demand loan is any loan which is payable in full at any time upon the demand of the lender. A term loan is any loan which is not a demand loan.

Gift loans.—A gift loan is any below-market loan where the foregone interest is in the nature of a gift. In general, there is a gift if property (including foregone interest) is transferred for less than full and adequate consideration under circumstances where the transfer is a gift for gift tax purposes. A sale, exchange, or other transfer made in the ordinary course of business (i.e., a transaction which is bona fide, at arm's length and free from any donative intent) generally is considered as made for and full and adequate consideration. A loan between unrelated persons can qualify as a gift loan.

It was intended that if a taxpayer makes a below-market demand loan to a trust and the loan is treated as a revocable transfer of property for purposes of Subpart E, the provisions of Subpart E govern.[8] Further, the Congress anticipated that regulations may be prescribed by the Treasury describing the circumstances under which a loan to a trust will be treated as a revocable transfer.

The Congress intended that, the case of a below-market loan to a section 501(c)(3) organization, the deemed payment from the lender to the borrower be treated as a contribution of cash and not as a contribution of a partial interest in property to which section 170(f)(3)(A) would apply.

Compensation-related loans.—A compensation-related loan is any below-market loan made in connection with the performance of services directly or indirectly between (1) an employer and an employee, or (2) an independent contractor and a person for whom such independent contractor provides services.

The Congress intended that an arrangement be treated as a compensation-related loan if, in substance, there is a compensatory element arising from the transaction. Thus, for example, a below-market loan by an employer to a child of an employee generally will be recharacterized under the provision as a compensation-related loan by the employer to the employee and a gift loan by the employee to the child.

The Congress intended that if an employer makes a payment to an unrelated third-party lender to buy-down a mortgage loan for an employee and, taking into account all the facts and circumstances, the transaction is in substance (1) a loan at a market rate by a third-party lender to the employee, and (2) a payment by the employer to secure a valuable benefit for the employee, the payment by the employer to the lender is to be treated as compensation under generally applicable principles of tax law. To that extent, the below-market loan rules do not apply. However, if the transaction is in substance a loan by the employer made with the aid of services provided by the third-party lender acting as an agent of the employer, there is a compensation-related loan subject to this provision.

Also, if an employee receives payment from a customer for services rendered on behalf of an employer, and is permitted to retain the money for a period without paying interest at a rate equal to or greater than the applicable Federal rate, there is generally a compensation-related loan. For example, if an investment banker is permitted by an issuer to retain the proceeds from a public offering of stock or debt for a period without paying interest, there is a below-market loan from the issuer to the banker. To the extent the benefit is in lieu of a fee for services, the loan is a compensation-related loan.[9]

In the case of a compensation-related loan, the deemed payment by the lender to the borrower is treated as wages for purposes of chapter 21 (the Federal Insurance Contributions Act), chapter 22

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[8] This result is required because it would be anomalous to give effect for tax purposes to a loan made by a taxpayer to himself or herself.

[9] To the extent the benefit is not in lieu of a fee for services, such an arrangement nevertheless may have a significant effect on the tax liability of the lender or the borrower. If so, the loan may be treated under regulations as a loan subject to the provision.

(the Railroad Retirement Tax Act), and chapter 23 (the Federal Unemployment Tax Act) of the Code. Further, unless otherwise provided in regulations, a payment must be included in gross income by the borrower, even if the borrower is likely to be entitled to an offsetting deduction.

The Act provides that demand loans are exempt from wage withholding under chapter 24. The Congress intended that term loans also be exempt from wage withholding. A technical amendment may be required to effectuate this intent. Finally, even though there is no wage withholding, the Congress intended that all deemed payments be reported under the appropriate information reporting provision.

Corporation-shareholder loans.—A corporation-shareholder loan is any below-market loan made directly or indirectly between a corporation and any shareholder of such corporation.

Tax avoidance loans.—A below-market loan is a tax-avoidance loan if one of the principal purposes of the interest arrangement is the avoidance of any Federal tax by either the borrower or the lender. Tax-avoidance is a principal purpose of the interest arrangement if it is a principal factor in the decision to structure the transaction as a below-market loan, rather than a loan requiring the payment of interest at a rate that equals or exceeds the applicable Federal rate and a payment by the lender to the borrower.

Other below-market loans.—A loan that is not a gift loan, compensation-related loan, corporation-shareholder loan or tax avoidance loan may be subject to these provisions under Treasury regulations if the interest arrangement has a significant effect on the tax liability of the borrower or the lender.

The interest arrangement of a below-market loan has an effect on the tax liability of the borrower or the lender if, among other things, it results in the conversion of a nondeductible expense into the equivalent of a deductible expense. Generally, there is such a conversion when a taxpayer makes a non-interest bearing refundable deposit in partial or total payment of the cost of a nondeductible item or expense. For example, if a member of a club makes a non-interest bearing refundable deposit to the club in lieu of part or all of his or her membership fee, the member is paying the fee with money that has not been included in his income (i.e., the investment income from the proceeds of the deposit), and has, in effect, converted the fee into the equivalent of a deductible expense.

Another example of a below-market loan that may have such a tax effect, and which may be subject to the provision under regulations, is a below-market refundable deposit to a life-care facility by a resident of such facility. The Congress anticipated that any regulations providing for the application of the provision to such deposits will only apply to deposits made after the date the regulations are issued.[10]

The Congress anticipated that in determining whether an effect is significant, the Treasury will consider all the facts and circumstances, including (1) whether items of income and deduction gener-

[10] See 130 Cong. Rec. S. 14505 (daily ed. October 11, 1984) (colloquy between Sen. Dole and Senators Heinz and Chiles).

ated by the loan offset each other, (2) the amount of such items, (3) the cost to the taxpayer of complying with the provision, and (4) any non-tax reasons for deciding to structure the transaction as a below-market loan rather than a loan with interest at a rate equal to or greater than the applicable Federal rate and a payment by the lender to the borrower.

In general, the Congress did not intend that the provision apply to below-market loans in the form of interest-bearing or other accounts in a financial institution in the ordinary course of its trade or business, loans by a financial institution in the ordinary course of its trade or business, loans by an insurance company to a policyholder of the cash value of such policyholder's insurance policy, or to most loans subsidized by the government (such as government insured or guaranteed student loans or residential mortgages). Further, the Congress did not intend that the provision apply to any below-market program-related loan by a private foundation or other charitable organization. It was intended, however, that the rules generally applicable to compensation-related loans apply to below-market loans by banks to employees.

Timing and amount of transfers

The Act provides different rules for the timing and amount of the transfers described above depending upon whether the loan is (1) a gift loan or a non-gift demand loan, or (2) a loan other than a gift loan or a non-gift demand loan.

Term loans other than term gift loans.—Generally, in the case of a term loan other than a term gift loan, the lender is treated as transferring to the borrower and the borrower is treated as receiving from the lender an amount equal to the excess of the amount of the loan over the present value of all principal and interest payments due under the loan. This transfer is treated as occurring on the date the loan is made. The present value of all principal and interest payments is to be determined under regulations using a discount rate equal to the applicable Federal rate. The Congress believed that this treatment reflects the substance of the transaction. Further, treating the transfer from the lender to the borrower as occurring on the date the loan is made is consistent with the treatment of deferred compensation under section 83, which taxes transfers of property in connection with the performance of services when there is no substantial risk of forfeiture.

In addition, an amount equal to the excess of the amount of the loan over the present value of the payments due under the loan is treated as original issue discount. As a result, the borrower is treated as transferring to the lender, and the lender is treated as receiving from the borrower, interest income at a constant rate over the life of the loan. The interest which the borrower is treated as paying is deductible to the same extent as interest actually paid by the borrower.[11]

Demand loans and term gift loans.—Generally, in the case of a demand loan, the lender is treated as transferring to the borrower,

[11] No deduction would be allowable for such interest in cases where the borrower does not itemize deductions for the relevant year or the deductions would be disallowed under other provisions of the Code (e.g., sections 163(d) or 265)).

and the borrower is treated as receiving from the lender, an amount equal to the foregone interest on an annual basis. The Congress believed that this rule is appropriate for demand loans because the borrower's right to the use of the funds is always subject to a substantial risk of forfeiture and no avoidance of the rules of section 83 is possible. In the case of a term gift loan, the lender is treated as transferring to the borrower, and the borrower is treated as receiving from the lender, an amount equal to the excess of the amount of the loan over the present value of all principal and interest payments due under the loan.

In addition, in the case of a demand loan or a term gift loan, the borrower is treated as transferring to the lender, and the lender is treated as receiving from the borrower, an amount equal to the foregone interest on an annual basis. This foregone interest is included in income by the lender and deductible by the borrower to the same extent as interest actually due on the loan from the borrower. The Congress believed it is appropriate to apply this rule to term loans that are gift loans, because, in light of the familial or other personal relationship that is likely to exist between the borrower and the lender, the technical provisions of the loan, such as the maturity of the loan, may not be viewed as being binding by the parties. In addition, under the provisions generally applicable to term loans, an original issue discount analysis is required to determine the timing and amount of the deemed transfers by the borrower to the lender. By treating term gift loans as demand loans for these purposes, such analysis is avoided.

An example is illustrative. Assume that on January 1, P, a calendar year taxpayer, makes a $200,000 loan to S, a calendar year taxpayer, for two years at 5 percent simple interest payable annually. If the applicable Federal rate is 12 percent compounded semiannually, the amount treated as transferred by the lender to the borrower for gift tax purposes would be $24,760 (i.e., the excess of $200,000 over the present value of all payments due under the loan discounted at the applicable Federal rate). The amount treated as retransferred by the borrower to the lender on the last day of each of the two calendar years would be $14,720 (i.e., the excess of interest computed at the applicable Federal rate (compounded semiannually) over interest actually payable on the loan). This amount, which would be included in income by the lender and, subject to the rules governing the deductibility of interest, deductible by the borrower, would be in addition to the $10,000 actually due each year under the terms of the loan.

Compensation-related deemed demand loans.—The Act provides that, for purposes of determining the timing and amount of the transfers deemed made under the provision, a compensation-related term loan is treated as a demand loan if it is (1) non-transferable and (2) conditioned on the future performance of substantial services by the employee.[12] The Congress intended that a loan be treated as non-transferable if the benefit derived by the employee from the interest arrangement cannot be transferred by the em-

[12] For purposes of this discussion, the term employee is used to refer to employees and independent contractors.

ployee. A technical amendment may be necessary to effectuate this intent.

The Congress intended that a benefit be treated as non-transferable and conditioned on future performance under this provision so long as it would be treated as non-transferable and conditioned on future performance under section 83. For example, a benefit would be conditioned on the future performance of substantial services if the parties provide that, on the termination of the employee's employment, the loan will become due and payable, or the interest rate will be increased so that the rate for the remaining term of the loan equals or exceeds the applicable Federal rate.

Where the terms of the loan change, either because of an amendment or the happening of an event, the treatment of the loan during a subsequent period as a term loan or as a demand loan is to be determined under the terms of the loan after such amendment or event.

Applicable Federal rate

Under the Act, the adequacy of any stated interest, and the amount of any deemed payments are determined by reference to an applicable Federal rate as determined under section 1274(d).[13] For any period beginning on or after January 1, 1985, there will be three such rates: a short-term rate; a mid-term rate; and a long-term rate. In the case of a demand loan, the relevant rate generally is the short-term rate. In the case of a term loan, the relevant rate is determined by reference to the term of the loan, as set forth below:

Term	Rate
3 years or less	The Federal short-term rate
Over 3 years but not over 9 years	The Federal mid-term rate
Over 9 years	The Federal long-term rate

These rates are to be determined by the Treasury within 15 days after the close of 6-month periods ending on September 30 and March 31, respectively, and are to reflect the average market yield during such 6-month periods on outstanding marketable obligations of the United States with comparable maturities.

The rates determined to reflect the average yield for a 6-month period ending on September 30 are applicable during the 6-month period beginning on January 1 of the succeeding calendar year. The rates determined to reflect the average yield for the period ending on March 31 are applicable during the 6-month period beginning on the following July 1.

[13] Section 1288 provides, in part, that the Treasury Secretary will make appropriate adjustments to the applicable Federal rate to take into account the tax exemption on an obligation to which section 483 or section 1274 applies. Section 133 provides for an exclusion from gross income of 50-percent of the interest income on a "securities acquisition loan" (relating to loans involving an employee stock ownership plan). Congress intended that the adjustment provided by section 1288 include adjustments for the 50-percent interest exclusion under section 133 and that the adjusted rate would apply to securities acquisition loans for purposes of section 7872.

Under the Act, in the case of a term loan, the applicable Federal rate is the rate for the day on which the loan is made. In the case of a demand loan, amounts are treated as transferred and retransferred on a daily basis, and the applicable Federal rate for any day is the relevant rate for the 6-month period in which such day falls. Further, in the case of a demand loan, the relevant applicable Federal rate is always the Federal short-term rate.

For purposes of determining the applicable Federal rate, a compensation-related term loan is treated as a term loan even if such loan is treated as a demand loan for some other purposes of the Act. Thus, if an employer makes a 10-year term loan to an employee and the interest arrangement is (1) non-transferable by the employee and (2) conditioned on the future performance of substantial services by the employee, the adequacy of any stated interest and the amount of any deemed payments are determined by reference to the long-term rate in effect for the day the loan is made.

The Act provides that in the case of a term loan, the applicable Federal rate is to be compounded semiannually. The Congress intended that the rate also be compounded semiannually when applied in the case of a demand loan. In this regard, the Treasury has announced that beginning on January 1, 1985, the Federal short-term, mid-term, and long-term rates, compounded semiannually, will be 12.01 percent, 12.95 percent, and 13.01 percent, respectively. See Rev. Rul. 84-163, 1984-47 I.R.B. 25.

A single rate of 10 percent compounded semi-annually applies for purposes of section 7872 prior to January 1, 1985.

De minimis exceptions

The Act provides specific de minimis rules. For purposes of applying these rules, all loans between the same parties are aggregated.

De minimis exception for gift loans between individuals.—As a general rule, no amount is treated as transferred by the lender to the borrower, or retransferred by the borrower to the lender, for any day during which the aggregate outstanding amount of loans does not exceed $10,000. Further, the Congress intended that a term gift loan generally will not result in an imputed gift for gift tax purposes if the aggregate amount owed by the borrower to the lender on the day the loan is made does not exceed $10,000. For this purpose, the aggregate outstanding amount of loans includes all loans between the lender and the borrower regardless of the rate of interest.

This de minimis rule does not apply if the loan is directly attributable to the purchase or carrying of income producing assets. Although a "directly attributable" test requires that there be some direct link between the loan and the borrower's purchase or continued ownership of income-producing assets, this is an anti-abuse provision, and the Congress anticipated that it will be interpreted in light of its purpose of preventing the avoidance of the assignment of income rules and the grantor trust rules.

Because a term gift loan is treated as a demand loan for purposes of determining the timing and amount of the deemed transfers by the borrower to the lender, generally no amount is deemed transferred by the borrower to the lender for any day on which the aggregate amount owed is $10,000 or less. Thus, if the balance of a term gift loan fluctuates, there may be income tax consequences for some days but not for other days.

De minimis exception for compensation related loans and corporation shareholder loans.—A de minimis exception is provided for loans between (1) an employer and an employee, or an independent contractor and a person for whom such independent contractor provides services, or (2) a corporation and a shareholder of such corporation. Under these rules, in the case of a demand loan, no amount is treated as transferred by the lender to the borrower, and retransferred by the borrower to the lender, for any day during which the aggregate outstanding amount owed by the borrower to the lender does not exceed $10,000. In the case of a term loan, no amount is treated as transferred or retransferred if on the day the loan is made the aggregate outstanding amount owed by the borrower to the lender does not exceed $10,000. However, in the event of a reduction in the outstanding balance of a term loan below $10,000, the provision continues to apply. Thus, the borrower is treated as transferring to the lender, and the lender is treated as receiving from the borrower, foregone interest on the remaining outstanding balance.

In the case of corporation-shareholder or employer-employee loans that are term loans, the deemed transfers from the lenders to the borrowers are treated as occurring on the latter of the dates on which the loans are made or on the first date on which the loans are subject to the provision. Thus, for example, if there are no other outstanding loans between an employer and an employee, and the employer makes a $9,000 compensation-related term loan to the employee on April 9, and a $2,000 demand loan to the same employee on April 10, both loans are subject to the provision, and the de minimus rules do not apply to either loan, as of April 10.

This de minimis rule does not apply if a principal purpose of the interest arrangement is the avoidance of any Federal tax.

Special rules for gift loans.—The amount treated as retransferred by the borrower to the lender for any day on which the aggregate outstanding amount of loans between the lender and the borrower does not exceed $10,000 is limited to the borrower's net investment income for the year. If the borrower has outstanding two or more gift loans, net investment income is allocated among such loans in proportion to the respective amounts that would be treated as retransferred by the borrower without regard to this limitation.

The term net investment income has the same meaning as it does for purposes of section 163(d)(3). Thus, the term generally means the excess of investment income over investment expense. The term investment income generally means (1) the gross income from interest, dividends, rents and royalties, (2) the net short-term capital gain attributable to the disposition of property held for investment, and (3) any amounts treated under sections 1245, 1250, and 1254 as ordinary income, but only to the extent such income, gain and amounts are not derived from the conduct of a trade or business. The term investment expense generally means the deductions allowable under sections 162, 164(a)(1) or (2), 166, 167, 171, 212, or 611 directly connected with the production of income.

In addition, if a borrower has less than $1,000 of net investment income for the year, such borrower's net investment income for the year is deemed to be zero. Thus, if the aggregate outstanding amount of loans from the lender to the borrower does not exceed $100,000 on any day during a year, and the borrower has less than $1,000 of net investment income for the year, no amount is treated as retransferred by the borrower to the lender for such year.

The Act provides that, for purposes of computing net investment income under this rule, any amount which would be included in gross income by reason of section 1272 (relating to original issue discount) if such section applied to all deferred payment obligations is treated as interest. The term deferred payment obligations includes any market discount bond short-term obligation, United States savings bond, annuity, or similar obligation.

The Congress anticipated that the Treasury will prescribe regulations to prevent the abuse of these special rules for gift loans through the deferral or other distortion of a borrower's net investment income. It was anticipated that these regulations will apply to situations in which a party can control the timing of the receipt of investment income (e.g., where the borrower can control the timing of dividends paid by a closely-held corporation) or has engaged in any activities a principal purpose of which is to defer receipt of net investment income. Further, it is anticipated that regulations will provide for determinations under these provisions in cases in which either the borrower or lender computes taxable income on the basis of a fiscal year.

These special rules for gift loans do not apply if a principal purpose of the interest arrangement is the avoidance of Federal taxes.

Other exceptions.—This section does not apply to any loan to which section 483 or 1274 applies.

Regulations

Under the Act, the Treasury is directed to prescribe such regulations as may be necessary or appropriate to carry out the purposes of the section, including (but not limited to) regulations providing for the application of the section in cases involving varying rates of interest, conditional interest payments, waivers of interest, or other circumstances. For example, the Congress anticipated that regulations may provide that if a loan is made requiring the payment of interest and the interest is waived, cancelled, or reduced, the lender will have income if the waiver, cancellation, or reduction is in the nature of a gift, payment of compensation, dividend, contribution to capital or other similar payment.

As stated above, the regulatory authority granted to the Treasury Department includes the authority to modify the generally applicable rules where appropriate to carry out the purposes of the statute. Pursuant to this authority, the Treasury Department may provide for the application of lower Federal rates where the statutorily-determined rates are significantly higher than current interest rates due to a decline in rates between the base period and the beginning of the effective period, or during the period the rates are in effect.

The authority granted to the Treasury Department also includes the authority to issue regulations exempting from these provisions any class of transactions if the interest arrangements do not have a significant effect on the tax liability of the borrower or the lender. The Congress anticipated that, in appropriate circumstances, compensation-related loans, including employee-relocation loans, may be exempted by these regulations. The term "significant effect" has the same meaning for this purpose as it does for purposes of determining whether loans not otherwise covered by the provision should be subject to it under regulations.

Authority is also provided to issue regulations for the purpose of assuring that borrowers and lenders take consistent positions under this provision. In appropriate cases, these regulations may condition a deduction for imputed interest on adequate identification of the lender.

In addition, authority is provided to issue regulations concerning the tax consequences of a disposition by a lender or a borrower of his or her interest in a below-market loan, or the acquisition of an interest in such a loan.

Other

The Congress intended that loans under Federal rural low-income housing programs, such as the Farmers Home Administration section 515 program, that provide for a market rate of interest, and a reduction in loan payments to compensate the borrower for the lower rents charged, are not to be considered below-market interest rate loans, provided the principal balance of the loan is amortized in accordance with the market rate of interest.[14]

Effective Dates

In general, the provision applies to term loans made after June 6, 1984, and to amounts outstanding on demand loans after such date. Amounts outstanding on demand loans on June 6, 1984, will not be subject to the provision if repaid prior to 60 days after the date of enactment. Further, the Congress intended that amounts outstanding on demand loans on June 6, 1984, not be subject to the provision if, prior to 60 days after the date of enactment, the terms of the loan are amended to require the payment of interest at a rate equal to or greater than the applicable Federal rate. No inference is intended with respect to the application of prior law to any below-market loan outstanding prior to the effective date.

Compensation-related term loans that are otherwise treated as demand loans for purposes of determining the timing and amount of the deemed transfers under the provision are treated as term loans for purposes of this effective date provision.

Revenue Effect

These provisions are estimated to increase fiscal year budget receipts by $44 million in 1984, $136 million in 1985, $167 million in 1986, $188 million in 1987, $211 million in 1988, and $237 million in 1989.

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[14] *See* 130 Cong. Rec. S. 8408 (daily ed. June 27, 9184) (statement of Sen. Dole).

3. Modification of Income Averaging (sec. 173 of the Act and secs. 1301 and 1302 of the Code)[15]

Prior Law

Under prior law, an eligible individual with more than $3,000 of averageable income, defined as the excess of current year taxable income over 120 percent of average taxable income in the previous four years, may have been eligible for income averaging. This procedure served to determine tax liability attributable to averageable income with reference only to the marginal rates applicable to the first 20 percent of this amount, rather than the higher marginal rates which would have applied if 100 percent of averageable income were taxed using the regular rate schedule. In other words, income averaging "widened" the tax brackets by a factor of five with respect to averageable income.

An individual eligible for income averaging first calculated what tax liability would be on 120 percent of average taxable income in the previous four years ("average base period income"). Then the individual computed the increase in tax liability over that amount which would result if 20 percent of averageable income were added to 120 percent of average base period income. This increase was then multiplied by five and added to the tax liability calculated on 120 percent of base period income in order to determine the individual's tax liability for the current year. All tax liability computations described in this paragraph were performed using the current year's rate schedules.

Reasons for Change

Although income averaging was originally intended to benefit taxpayers with either widely fluctuating income or a sharp jump in real income, in many recent years taxpayers whose income has increased merely at the rate of inflation have been eligible for income averaging. As a result, the percentage of taxpayers using income averaging has increased substantially. In 1970, only 1.35 percent of tax returns used income averaging. By 1981, this percentage had increased to 6.87 percent. Beginning in 1985, this problem would be magnified by indexing, because indexing itself will keep marginal tax rates constant for an individual whose increases in income are wholly attributable to inflation. Thus, in the absence of the provision in the Act, taxpayers could have received a double benefit from indexing and income averaging. Congress believed

[15] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 165; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1385-1386; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 178; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 488-489; and H. Rep. No. 98-861 (June 23, 1984), pp. 1036-1037 (Conference Report).

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that such a double benefit is inappropriate. Furthermore, the 23-percent across-the-board reduction in marginal tax rates enacted in 1981, including a top rate of 50 percent on ordinary income and 20 percent on long-term capital gains, greatly reduced the need for an income averaging provision as generous as that provided by prior law.

Explanation of Provision

The Act defines averageable income as the amount by which the taxable income for the current year exceeds 140 percent (rather than 120 percent as under prior law) of the average base period income. In addition, the base period is shortened to the three prior years. Finally, the income averaging formula is modified so that it widens the tax brackets by a factor of four with respect to averageable income. As a result of these changes, only those taxpayers with an unusual increase in income will receive a benefit from using income averaging, rather than taxpayers with more normal increases in income who also benefited under prior law.

Effective Date

The provision applies to taxable years beginning after December 31, 1983 (and to base period years applicable to such computation years).

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $133 million in 1984, $1,994 million in 1985, $1,886 million in 1986, $2,053 million in 1987, $2,226 million in 1988, and $2,404 million in 1989.

4. Treatment of Certain Related Party Transactions (sec. 174 of the Act and sec. 267 of the Code)[16]

Prior Law

Under prior law, an accrual-basis taxpayer was denied a deduction for certain accrued expenses or interest owed to related persons who use the cash method of accounting (sec. 267(a)(2)). The disallowed interest and business expenses were those which were not paid to the related person within the taxable year in which the expenses accrued or within 2 1/2-months thereafter. This provision prevented an accrual-basis taxpayer from claiming a deduction for an accrued expense which the related cash-basis payee was not required to take into income until some subsequent time, if at all.

Because an accrued expense is deductible by a taxpayer under the accrual method of accounting only in the taxable year in which it accrues, a deduction disallowed under section 267(a) was permanently lost. It could not be deducted at some subsequent time when payment was made.

Prior law placed a subchapter S corporation on the cash method of accounting for purposes of deducting business expenses and interest owed to a related cash-basis taxpayer, including a shareholder who owned at least two percent of the stock in the corporation. Thus, the corporation's deductions (which in the case of a subchapter S corporation are taken into account on the shareholders' returns) were allowed at the same time the income was recognized by the shareholder. Furthermore, no deductions were lost if payment was made after the 2 1/2-month period expired. Prior law did not provide a similar rule for payments between an accrual basis partnership and a cash basis partner, although present and prior law require that guaranteed payments made to a partner be includible in the partner's taxable year corresponding to the year the partnership deducted the payment (secs. 706(a) and 707(c))(an accrual rule).

Finally, prior law provided that no deduction was allowed for losses from sales or exchanges of property between related parties, including controlled partnerships (secs. 267(a)(1) and 707(b)(1)). Any gain recognized on a subsequent disposition of the property by the related party was reduced by the disallowed loss.

[16] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 168; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1578-1580; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 180; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 494-497; and H. Rep. No. 98-861 (June 23, 1984), pp. 1032-1034 (Conference Report).

Reasons for Change

Congress believed that persons who are related should be required to use the same accounting method with respect to transactions between themselves in order to prevent the allowance of a deduction without the corresponding inclusion in income. The failure to use the same accounting method with respect to one transaction involves unwarranted tax benefits, especially where payments are delayed for a long period of time, and in fact may never be paid.

Congress also believed that the prior rules denying a deduction entirely lead to an unduly harsh result where payment was in fact made more than 2-1/2 months after the close of the taxable year, while allowing too much of a tax advantage (i.e., effectively a one year's deferral) for payments made within 2-1/2 months after the close of a taxable year.

Finally, Congress believed that certain related parties, such as a partnership and its partners, and controlled corporations should be made subject to the related party rules in order to prevent tax avoidance on transactions between those parties.

Explanation of Provision

In general

Under the Act, a taxpayer is generally placed on the cash method of accounting with respect to the deduction of amounts owed to a related cash-basis taxpayer (sec. 267(a)(2)).[17] Thus, a taxpayer is allowed to deduct amounts owed to a related cash-basis taxpayer when payment is received by the related party payee (whether or not paid within 2-1/2 months after the close of the taxable year) or, if later, when otherwise deductible. In other words, the deduction by the payor is allowed no earlier than when the corresponding income is recognized by the payee.[18] This provision applies to all deductible expenses (whether or not deductible under section 162, 163 or 212) the timing of which depends upon the taxpayer's method of accounting or upon the making of an election to expense an item. It does not apply, for example, to expenses such as the deductions for cost recovery or depreciation of an asset (other than an asset which is related to the performance (or nonperformance) of services by the payee).[19]

Treatment of partnerships and S corporations

The prior-law rules relating to accruals by subchapter S corporations to cash basis shareholders are extended to accruals by partnerships to cash basis partners, as well as to accruals by partners to cash basis partnerships and shareholders to cash basis subchap-

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[17] This provision will not apply, for example, to original issue discount allowable as a deduction under section 163(e) and required to be included in income of the related party creditor under the accrual method by reason of section 1272.

[18] The application of this provision is not entirely clear in all situations involving amounts owed to related foreign corporations which are not included in gross income under section 882(b). However, this provision would not delay the deduction beyond the time payment is received by the payee (or, if later, when otherwise deductible).

[19] See also Treasury Temporary regulations sec. 1.267(a)-2T(b) for rules relating to new section 267(a)(2).

ter S corporations (sec. 267(e)). Also, the 2-percent de minimis exception for shareholders of subchapter S corporations is eliminated.

This cash basis rule applies to any payment made to a partner holding (actually or constructively) any capital interest or profits interest in the partnership or to any person related to a partner (within the meaning of secs. 267(b) or 707(b)(1)). There will be no attribution of partnership interests between partners or of interests held by a subchapter C corporation to any shareholder owning less than 5 percent of the stock of the corporation.[20] The cash basis rule does not apply to guaranteed payments (within the meaning of sec. 707(c)) made to a partner because the present law accrual rule is continued. Also, this rule applies to amounts accrued by an "upper tier" partnership (or a partner in the "upper-tier" partnership) which is a partner in a "lower-tier" partnership to partners of the "lower-tier" partnership or to persons related to these partners. Finally, it applies to amounts accrued by partners (to other partners) on behalf of a partnership, such as those amounts which the payor partner is obligated to make under the terms of the partnership agreement.

To illustrate the foregoing, assume that a corporation owns a one percent profits interest in partnership X and a 51-percent capital and profits interest in partnership Y. Partnership X uses the accrual method of accounting and partnership Y uses the cash method. Under the Act, unpaid amounts owed by X to Y cannot be deducted by X until paid to Y, because Y is related to a partner of X by reason of section 707(b)(1)(A).[21]

Certain resyndications of low-income housing (within the meaning of sec. 189(e)(5)) are excepted from the new section 267(e) rules with respect to certain interest on indebtedness incurred for the purpose of acquiring the low-income housing or an interest in a partnership owning that housing and certain other related business expenses. The exception applies only if the expense or interest is unconditionally required to be paid within 10-years of the date incurred, and, in the case of interest, only if incurred at an annual rate not in excess of 12 percent. The expense must be paid or incurred to a partner owning, directly or indirectly, an interest of 5 percent or less in the capital and profits of the partnership and only if the partner owned the housing at all times during the 2-year period prior to the transfer or the housing was acquired pursuant to a transfer from HUD or a state or local housing authority. This exception may apply, for example, where the expenses are in-

[20] The partnership constructive ownership rules of section 267(e)(3) are to apply for all purposes of section 267, such as for example, section 267(b)(10).

[21] If, however, the corporation has only a 40-percent interest in Y and, therefore, is not related to Y under section 707(b)(1), then the new rule will not specifically apply. However, see Treas. Reg. sec. 1.267(b)-(1) for prior law application of section 267 to partnerships. The Committee Reports stated that it was expected that the Treasury Regulations under this provision would provide a rule for cases not specifically covered by the new rules where the same persons are partners in both the payor partnership and payee partnership in order to ensure that the rules of section 267 cannot be avoided by the use of a partnership as an intermediary. The Reports stated that one approach would be to defer the deduction for accruals (until paid) to the extent of such partners' aggregate interests in the payor partnership. The Treasury Department has set forth rules relating to accruals between commonly-owned partnerships (Question and Answer number 3 of Temporary Treasury regulation sec. 1.267(a)-2T(c)).

curred by an upper-tier partnership to a partner of a lower-tier partnership.[22]

Controlled corporations, etc.

Finally, the Act generally extends the provisions of section 267 (as well as provisions of the Code applicable to related parties defined under section 267) to transactions between members of the same controlled group of corporations (sec. 267(b)(3) and (f)). For this purpose, corporations will be treated as members of the same controlled group under the controlled corporation rules of section 1563(a), except that a 50-percent control test will be substituted for the 80-percent test.[23]

In the case of controlled corporations, losses will be deferred (rather than disallowed) until the property is transferred outside the group and there would be recognition of loss under the consolidated return principles, or until such other time as is provided by regulations.

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

To the extent provided in regulations, any loss sustained on the repayment of a loan to another member of the controlled group will not be disallowed if the loan is payable or denominated in a foreign currency and the loss is attributable to a reduction in value of the foreign currency.

Except as otherwise provided in regulations, sales of inventory in the ordinary course of business between two corporations at least one of which is a foreign corporation are not subject to the loss deferral rule. This exception will only apply if the sales are made for bona fide business purposes. The IRS may apply the loss deferral rule where sales are made for the purpose of accelerating losses. An abnormally large volume of sales near the end of the year would be an indication of a purpose to accelerate losses, absent evidence to the contrary. Also, transfers to a DISC[24] are not subject to

[22] See also Treasury Temporary regulations sec. 1.267(a)-2T(c) for rules relating to application of section 267(a)(2) to partnerships.

[23] The component member rules of section 1563(b) are intended to have no application in determining whether corporations are members of the same controlled group, for purposes of new section 267(b)(3). Also, in determining whether corporations are members of the same controlled group, the constructive ownership rules of section 1563 (and not those of section 267(c)) are to apply.

[24] This exception does not apply to transfers to a Foreign Sales Corporation. In light of the purpose of this provision, Congress would intend that the Internal Revenue Service closely scrutinize, under section 482 or other relevant provisions, sales of assets other than receivables.

the loss deferral rules in order to allow losses to be recognized on receivables sold to a DISC.[25]

The section 267 rules also are extended to transactions between a partnership or subchapter S corporation and a regular corporation which are commonly controlled (sec. 267(b)(10) and (12)).

Finally, portions of sections 170, 514 and 1235 are amended to treat related parties under the provisions of section 707(b) as related for purposes of those provisions.

Effective Date

The provisions relating to timing of accruals (sections 267(a) and 267(e)) apply to taxable years beginning after December 31, 1983. The expansion of related party rules (secs. 267(b) and 267(f)) apply to transactions after that date. However, the amendments made by this Act section do not apply to (1) interest on indebtedness incurred on or before September 29, 1983, or incurred pursuant to a contract binding on that date and all times thereafter and (2) other expenses made pursuant to a contract which was binding on September 29, 1983, and at all times thereafter.

Transfers to a controlled foreign corporation will be subject to the new rules only after March 1, 1984.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $46 million in 1984, $109 million in 1985, $176 million in 1986, $253 million in 1987, by $346 million in 1988 and by $416 million in 1989.

[25] See also Treasury Temporary regulations secs. 1.267(f)-1T and 1.267(f)-2T for rules relating to new sections 267(b)(3) and 267(f).

5. Transfers of Depreciable Property Between Related Parties (sec. 175 of the Act and sec. 1239 of the Code)[26]

Prior Law

In order to prevent tax-motivated transactions, transfers between related parties often received special treatment under the Internal Revenue Code. One provision provided that a transferor would be treated as receiving ordinary income rather than capital gain on the transfer of property to a related party when that property was depreciable property in the hands of the transferee (sec. 1239). For this purpose, related parties included a person and all corporations or partnerships controlled by that person.

The courts have held that the transfer of a patent application as opposed to a patent does not fall within this anti-abuse rule because the application itself is not depreciable property (*Lan Jen Chu v. Commissioner*, 486 F.2d 696 (1st Cir. 1973)). However, once the application is granted, the transferee can depreciate the resulting patent.

Reasons for Change

Congress believed that the scope of section 1239 should be broadened in order to prevent taxpayers from effectively selling certain property to themselves at capital gains rates and receiving cost recovery benefits on a stepped-up basis.

Explanation of Provision

The provision of the Code relating to gains from the sale of depreciable property between related parties (sec. 1239) is amended to treat a patent application as depreciable property, thus requiring that any gain recognized to the transferor be treated as ordinary income rather than capital gain.

Also the definition of related persons is expanded to include a taxpayer and trust in which the taxpayer has a beneficial interest (other than a remote contingent interest).

Effective Date

The provision applies to transfers after March 1, 1984.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by less than $5 million annually.

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[26] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 167; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), p. 1390; and H. Rep. No. 98-861 (June 23, 1984), p. 1032 (Conference Report).

6. Recapture of Net Ordinary Losses Under Section 1231 (sec. 176 of the Act and sec. 1231 of the Code)[27]

Prior Law

Under prior law, gains and losses on the sale, exchange, or involuntary conversion of property used in a trade or business, held for more than one year, were generally treated as long-term capital gains and losses if the total gains from all such transactions during the year exceed the total losses from such transactions during the year. If the losses for the year exceed the gains, the gains and losses were treated as ordinary gains and losses. Any gain subject to recapture under the Code (e.g., gain attributable to depreciation on section 1245 (personal) property and excess depreciation on section 1250 (real) property), however, was treated as ordinary income notwithstanding this rule.

Thus, if a taxpayer had a net gain from the specified types of transactions during a taxable year, the taxpayer could treat the gain as capital gain, generally paying tax at a lower tax rate, but if the taxpayer had a net loss, the full net loss would be allowed as a deduction from ordinary income.

Reasons for Change

The prior law rules relating to the treatment of gains and losses from sales and exchanges of trade or business property created distortions in taxable income in certain situations because they ignored transactions in prior and subsequent taxable years. The rules were subject to manipulation by taxpayers, who could bunch sales of appreciated trade or business assets in one year and sales of depreciated property in a different year to maximize their capital gains and ordinary losses.

Explanation of Provision

Under the Act, net section 1231 gains are treated as ordinary income to the extent of unrecaptured net section 1231 losses of the taxpayer (or predecessor taxpayer) for the five most recent prior years beginning after December 31, 1981. In determining the amount of unrecaptured net section 1231 losses for the five-year period, net gains for any year will be taken into account only to the extent they were previously recaptured as ordinary income. Losses are deemed recaptured in the chronological order they arose.

[27] For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec 181, S. Prt 98-169, Vol. I (April 2, 1984), pp. 498-499; and H. Rep. No. 98-861 (June 23, 1984), p. 1034 (Conference Report)

Effective Date

The provision is effective for taxable years beginning after December 31, 1984.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $27 million in 1985, $75 million in 1986, $99 million in 1987, $131 million in 1988, and $173 million in 1989.

7. Repeal of Tax Exemption of the Federal Home Loan Mortgage Corporation ("Freddie Mac") (sec. 177 of the Act, secs. 172 and 246 of the Code, and sec. 303 of the Federal Home Loan Mortgage Corporation Act)[28]

Prior Law

Tax-exempt status

Under prior law, the Federal Home Loan Mortgage Corporation ("Freddie Mac")[29] was exempt from all Federal, State, and local taxation, by terms of its enabling legislation (12 U.S.C. sec. 1452(d)). Real property held by Freddie Mac remained subject to State and local tax.

The 12 regional Federal Home Loan Banks, which control the stock of Freddie Mac, are themselves exempt from tax, under both prior and present law. However, the member savings institutions of the Home Loan Banks are subject to tax.

Net operating loss carrybacks

Under prior and present law (Code sec. 172), corporations are generally allowed a carryback of net operating losses to each of the three taxable years preceding the taxable year of the loss. In addition, for losses in taxable years beginning in 1976 or later, corporations are generally allowed a carryover of net operating losses to each of the 15 taxable years following the taxable year of the loss.

A special rule is provided under prior and present law for net operating loss carrybacks and carryovers of banks and other financial institutions, for losses attributable to taxable years beginning after December 31, 1975. These institutions are allowed a carryback of such losses to each of the 10 taxable years preceding the taxable year of the loss, and a carryover to each of the five succeeding taxable years. A similar 10-year carryback and 5-year carryover is provided for net operating losses of the Federal National Mortgage Association Association ("Fannie Mae"), for losses (other than losses from mortgage dispositions) attributable to taxable years beginning after December 31, 1981. In the case of losses from mortgage dispositions by Fannie Mae, the normal three-year carryback and 15-year carryover rules apply.

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[28] For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 187; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 508-512; and H. Rep. No. 98-861 (June 23, 1984), pp. 1037-1040 (Conference Report).

[29] Freddie Mac was chartered by Congress in 1970 as a wholly owned subsidiary of the Federal Home Loan Bank system. The corporation provides a secondary market for residential mortgages held by savings institutions and other lenders. In a typical arrangement, Freddie Mac packages mortgages into pools and sells securities backed by a pool of mortgages (e.g., "participation certificates") to investors. Freddie Mac is further authorized to offer a "swap" program under which lenders may exchange below-rate mortgages for mortgage-backed securities.

Dividends received deduction

Under prior and present law (Code sec. 243), a corporation is generally entitled to a deduction for 85 percent of the amount of dividends received from other domestic corporations. This deduction does not apply if the corporation paying the dividend is itself exempt from tax (sec. 246(a)). Thus, under prior law, dividends received by savings institutions from a Federal Home Loan Bank[30] did not qualify for a dividends received deduction.

Income from discharge of indebtedness

A discharge of indebtedness for less than its principal amount generally results in income to the party discharging of the indebtedness (Code sec. 61(a)(12)). For example, if a taxpayer is liable on an obligation having a principal amount of $100,000, and discharges the obligation for a payment of $80,000, the taxpayer recognizes $20,000 of income.

Reasons for Change

The tax exemption for Freddie Mac was originally intended to allow the corporation to accumulate adequate capital so that it could compete against other entities in the secondary mortgage market, including Fannie Mae, which is a taxable entity. The purpose of this tax exemption was not to provide Freddie Mac with a competitive advantage.[31]

In the past 14 years, Freddie Mac has become highly profitable and has accumulated sufficient capital to compete in the secondary mortgage market. As a result, Congress believed that the exemption from tax had fulfilled its function and had begun to provide Freddie Mac with a competitive advantage. Accordingly, Congress believed it appropriate to repeal the tax exemption for Freddie Mac.

While believing it appropriate to remove the tax exemption for Freddie Mac, Congress was aware that various differences exist between the corporate structure of Freddie Mac and Fannie Mae, its chief competitor, which may affect the ability of Freddie Mac to compete successfully in the secondary mortgage market once tax is imposed. Specifically, Freddie Mac has in the past sought legislation allowing it to issue common stock (as Fannie Mae now does) representing a direct private investment in the corporation. In principle, Congress supported the concept of equality between Freddie Mac and Fannie Mae in corporate as well as tax matters; however, for the reasons mentioned, Congress believed it appropriate to repeal the Freddie Mac tax exemption independently of any such "privatizing" legislation.

The Act imposes tax on Freddie Mac effective January 1, 1985. To ensure (to the extent possible) that tax is imposed on a prospective basis only, the Act provides various rules regarding the tax treatment of assets held by Freddie Mac as of that date. The Act also provides special treatment for net operating loss carrybacks

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[30] The Federal Home Loan Banks are tax-exempt under a non-Code provision.

[31] Cong. Rec., April 16, 1970, pp. 12232-12233 (statement of Sen. Sparkman). The tax exemption for Freddie Mac was added by amendment on the Senate floor.

and carryovers of Freddie Mac, which is equivalent to that provided under prior and present law for Fannie Mae. Additionally, the Act allows savings institutions a deduction for dividends received from the Federal Home Loan Banks where the dividends are allocable to Freddie Mac income which has already been subject to tax. This provision is designed to prevent imposition of a double corporate level tax on the income of Freddie Mac.

Finally, the Act includes a special rule designed to prevent rearrangements of the existing capital structure of Freddie Mac from yielding unintended tax benefits. Because the rule is designed for this purpose, it does not apply to obligations with respect to which Freddie Mac establishes that there is no tax avoidance effect.

Explanation of Provision

Repeal of tax-exempt status

General rule

The Act repeals the Federal tax exemption for Freddie Mac, effective January 1, 1985. The Act does not affect Freddie Mac's State and local tax exemption or its exemption from taxes imposed by U.S. possessions. Real property held by Freddie Mac remains subject to State and local taxes.

The Act provides that, for income tax purposes, Freddie Mac is to be treated as having no accumulated earnings and profits as of January 1, 1985. Under this rule, distributions paid out of earnings accumulated before January 1, 1985, are not treated as dividends (under Code sec. 316) and the tax treatment of such distributions is not affected by the Act. This provision was intended to ensure that the deduction for certain dividends received by savings institutions from the Home Loan Banks (discussed below) would apply only to the extent the dividends are allocable to post-1984 earnings and profits of Freddie Mac.

Basis of Freddie Mac assets

General rule.—Under the Act, the basis of assets held by Freddie Mac on January 1, 1985, will be determined under a different method depending upon whether the basis is being taken into account for purposes of determining gain or loss on disposition of the asset. For purposes of determining gain, the basis of any asset held on January 1, 1985, is to be the higher of (1) the regular adjusted basis of the asset in the hands of Freddie Mac (as determined under Code secs. 1011-1023) or (2) the fair market value of the asset on January 1, 1985. For purposes of determining loss, the basis of any asset held on January 1, 1985, is to be the lower of these two figures. Where the amount realized on the disposition of an asset is greater than the lower of these figures, but less than the higher figure, no gain or loss is to be recognized by Freddie Mac on the disposition.

For example, if a mortgage held by Freddie Mac on January 1, 1985, has a regular adjusted basis to the corporation, as of December 31, 1984, of $100,000, but (because of rising interest rates) has a fair market value of $80,000 on January 1, 1985, and if Freddie Mac later disposes of the mortgage for $70,000, Freddie Mac would recognize $10,000 of loss on the transaction ($70,000 minus $80,000). If, instead, the mortgage were disposed of (following a decline in interest rates) for $110,000, Freddie Mac would recognize $10,000 of gain ($110,000 minus $100,000). A disposition for a price between $80,000 and $100,000 would result in no taxable gain or loss by Freddie Mac.

Under the same principles, if Freddie Mac owns an asset on January 1, 1985 with a regular adjusted basis, as of December 31, 1984, of $100,000 and a fair market value of $150,000 on January 1, 1985, a subsequent disposition of the asset for $160,000 would result in $10,000 of taxable gain, while a disposition for $90,000 would result in a $10,000 loss. If the asset were disposed of for a price between $100,000 and $150,000, neither gain nor loss would be recognized.

Tangible depreciable property.—An exception to the general rules above is provided in the case of property depreciable under section 167 (e.g., buildings or office equipment) which is held by Freddie Mac on January 1, 1985. For such property, the adjusted basis, for purposes of determining gain or loss, is to be equal to the lesser of (1) the regular adjusted basis of the property in the hands of Freddie Mac, or (2) the fair market value of the property as of January 1, 1985. This rule is primarily intended to prevent Freddie Mac from being able to claim deductions based on pre-1985 depreciation of tangible property held by the corporation on the date of taxability.

Treatment of participation certificates (PCs)

The Act specifies that Freddie Mac is to be treated as having no basis in its income rights with respect to mortgage pool participation certificates ("PCs") or similar interests in mortgages, under the basis provisions of the Act, where the PC, similar interest, or any related security was sold or issued by Freddie Mac prior to January 1, 1985. This provision is intended to apply to (but is not limited to) collateralized mortgage obligations (CMOs) sold or issued by Freddie Mac prior to January 1, 1985. Thus, income received by Freddie Mac which is attributable to PCs, CMOs, or similar obligations sold prior to January 1, 1985, is to be taxable in the year received, regardless of whether such income is attributable to services performed by Freddie Mac prior to January 1, 1985, to guarantees provided by Freddie Mac, or to a built-in income or profit component which might be considered to exist as of January 1, 1985. Additionally, Freddie Mac is not to be entitled to a deduction for depreciation or amortization with respect to its income rights in these obligations and is to have no basis in such income rights, under the basis provisions of the Act, for purposes of determining gain or loss on the sale or disposition of such income rights.

Congress understood that Freddie Mac, prior to March 15, 1984, had not sold its income rights in PCs and similar interests in mortgages in the ordinary course of business, and intended to continue to hold such income rights in the ordinary course of its business. Accordingly, a sale of such interests during the remainder of 1984 would be presumed to be for the purpose of avoiding the effective date of taxation. The Act therefore provides a special rule for the treatment of any sales of income rights in PCs or similar interests in mortgages before the January 1, 1985, effective date. Under this special rule, gain realized by Freddie Mac on the sale of any of its income rights in PCs or similar interests in mortgages after March 15, 1984, and before January 1, 1985, is recognized on January 1, 1985 (and is thereby subject to tax).

Treatment of certain replacement obligations

The Act includes a special rule which denies Freddie Mac a deduction for interest accruing after December 31, 1984, on any replacement obligation. For this purpose, a replacement obligation means any obligation created after March 15, 1984, which the Treasury Department determines to replace any equity or debt interest of a Federal Home Loan Bank (or of any other person) in Freddie Mac which existed on March 15, 1984. This provision is intended to prevent any rearrangement of the existing capital structure of Freddie Mac (e.g., replacement of equity or low-interest debt with high-interest debt) from resulting in an unintended tax benefit. As such, the provision does not apply to any obligation with respect to which Freddie Mac establishes that there is no tax avoidance effect.

Carryback of net operating losses

For losses arising on or after January 1, 1985 (other than losses from mortgage dispositions), the Act allows Freddie Mac a net operating loss carryback to each of the 10 taxable years preceding the taxable year of the loss, and a carryover to each of the five taxable years following the taxable year of the loss. For losses from mortgage dispositions, the normal three-year carryback and 15-year carryover rules apply. These rules are equivalent to the prior and present law rules regarding net operating losses of Fannie Mae. Congress intended that the definition of a mortgage disposition loss is to be the same as that applied under prior and present law in the case of Fannie Mae.

Under a transitional rule, no net operating loss, capital loss, or excess credit of Freddie Mac for any taxable year beginning after December 31, 1984, is to be allowed as a carryback (under the 10-year or three-year method) to any taxable year beginning before January 1, 1985. This rule prevents Freddie Mac from being required to carry back losses or credits to years in which the corporation was not taxable (and in which the losses or credits are therefore without value to Freddie Mac), and allows such losses or credits instead to be carried forward to later taxable years.

Dividends received deduction

The Act allows shareholders of the Federal Home Loan Banks a dividends received deduction (under Code secs. 243-246) for that portion of dividends received from a Home Loan Bank which is allocable to dividends paid to the Home Loan Bank by Freddie Mac out of Freddie Mac earnings and profits for periods after December 31, 1984. (This deduction would otherwise not be allowed because of the tax-exempt status of the Home Loan Banks.) The computation of this deduction depends on whether the Home Loan Bank is paying its dividend out of current or accumulated earnings and profits of the Home Loan Bank.

For dividends paid out of current earnings and profits, a deduction is to be allowed with respect to that portion of the Home Loan Bank dividend which bears the same ratio to the total dividend as the ratio of (a) dividends received by the Home Loan Bank from Freddie Mac during the Home Loan Bank's current taxable year,[32] to (b) the total earnings and profits of the Home Loan Bank for the year. For example, if in 1985 a Home Loan Bank has $100 million of earnings and profits and receives $25 million of dividends from Freddie Mac, and the Home Loan Bank pays a dividend of $10 million to its shareholders, the shareholders would be allowed a deduction with respect to $2.5 million of such dividends received from the Home Loan Bank (i.e., $10 million x ($25 million of Freddie Mac dividends ÷ $100 million earnings and profits of the Home Loan Bank)). The actual amount of the deduction would be determined under the general rules applicable to the dividends received deduction, including the 40 percent aggregate reduction for dividends received by thrift institutions using the percentage of taxable income method for computing bad debt deductions (sec. 596).

If the amount of the dividends paid by a Home Loan Bank exceeds the bank's earnings and profits for the current taxable year, an allocation similar to that described above is to be made for accumulated earnings and profits. Under this allocation, a deduction is to be allowed for that portion of any dividend paid by a Home Loan Bank to its shareholders out of accumulated earnings and profits which bears the same ratio to the total dividend as the ratio of (a) the amount of dividends received by the Home Loan Bank from Freddie Mac which are out of Freddie Mac earnings and profits for taxable years ending after December 31, 1984, and which have not previously been treated as distributed by the Home Loan Bank in any year under the rules of this paragraph or the preceding paragraph, to (b) the total accumulated earnings and profits of the Home Loan Bank at the time the dividend is paid. Thus, continuing the example in the paragraph above, assume that throughout the year 1986 the Home Loan Bank has $150 million of accumulated earnings and profits. Assume further that the Home Loan Bank has no current earnings and profits for 1986, and that it distributes $20 million in dividends out of its accumulated earnings and profits during that year. The amount of the distribution that qualifies for the dividends received deduction in 1986 would be $1 million (i.e., $20 million x ($7.5 million in Freddie Mac dividends not treated as distributed in 1985 ÷ $150 million accumulated earnings and profits of the Home Loan Bank)).[33]

For purposes of this allocation rule, the retained earnings and profits of the Home Loan Bank as of January 1, 1985, are to be treated as its accumulated earnings and profits as of that date. No deduction is to be allowed for dividends paid by Home Loan Banks which are allocable to dividends paid by Freddie Mac out of earnings and profits which it accumulated before January 1, 1985 (i.e., prior to the date of taxability).

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[32] Except as otherwise provided in regulations, the taxable year of any Home Loan Bank will be considered to be the calendar year.

[33] This example assumes that the full Freddie Mac dividend was paid out of post-1984 earnings and profits of Freddie Mac.

Reserves for bad debts

Congress intended that Freddie Mac's deductions for additions to a reserve for bad debts are to determined in a manner comparable to Fannie Mae.

Effective Date

This provision is generally effective on January 1, 1985.

Special transitional provisions regarding accumulated earnings and profits of Freddie Mac, the adjusted basis of Freddie Mac assets, participation certificates, net operating loss carrybacks, and the treatment of certain replacement obligations are described above as part of the Explanation of Provision.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $67 million in 1985, $109 million in 1986, $142 million in 1987, $185 million in 1988, and $240 million in 1989.

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8. Use of Multicompany Structure to Reduce Tax on Coal Operations (sec. 178 of the Act and sec. 631 of the Code)[34]

Prior Law

Present and prior law (sec. 631(c)) provide that, subject to certain special limits, royalties received on the disposition of coal or iron ore qualify for capital gain treatment. For capital gain treatment to apply, the coal or iron ore must have been held for more than one year before mining. Capital gain treatment does not apply to income realized by an owner as a co-adventurer, partner, or principal in the mining of the coal or iron ore. If capital gain treatment is allowed for coal or iron ore royalties, the royalty owner is not entitled to percentage depletion with respect to the coal or iron ore disposed of. In the case of iron ore (but not coal), prior law denied capital gain treatment to a disposal to a related person or to a person owned or controlled directly or indirectly by the same interests which owned or controlled the person disposing of the ore.

Under prior law, it was possible to reduce the overall tax on coal mining operations by having a separate land-holding company acquire coal reserves and lease them for a retained arm's-length royalty to the company which actually conducts mining operations. Under such an arrangement, the royalties were deductible by the operating company, and the amount of the royalties received by the land company (after subtracting cost depletion and certain expenses) qualified for capital gain treatment. If the benefits of capital gain treatment exceeded the loss from foregoing percentage depletion on the coal in question, the overall tax on the operation was reduced. The Code specifically prohibited this result in the case of iron ore by denying capital gains treatment for dispositions to related persons.

Reasons for Change

Congress believed that the income tax of coal producers should be the same whether they operate through a single entity or a combination of related parties.

Explanation of Provision

The Act amends section 631(c) to specify that capital gain treatment does not apply to any disposal of coal to a related person or to a person owned or controlled directly or indirectly by the same interests which own or control the person disposing of the coal.

[34] For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 184; S. Prt. 98-169, Vol. I (April 2, 1984), p. 504; Senate floor amendment, 130 Cong. Rec. S4551, 4553 (April 12, 1984); and H. Rep. No. 98-861 (June 23, 1984), p. 1035 (Conference Report).

Effective Date

The provision generally is effective for coal disposed of (i.e., mined) after September 30, 1985. However, the provision does not apply to coal ultimately sold to a nonrelated person under a fixed contract in effect on June 15, 1984, and at all times thereafter before such sale, under which the price for the coal cannot be adjusted to reflect to any extent the increased liabilities of the seller for income tax by reason of the amendment. This exception for fixed contracts is limited to coal sold to a nonrelated person before terminates on January 1, 1990. For purposes of this effective date rule, if an operator sells coal under both fixed contracts and other contracts, unless the contract otherwise provide, the royalty subject to the new rules will be treated as paid first out of the proceeds from the fixed contracts.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $2 million in 1985, $10 million in 1986, $15 million in 1987, $17 million in 1988, and $18 million in 1989.

9. Limitations with Respect to Property That is Partially Used for Personal Purposes and Luxury Automobiles (sec. 179 of the Act and sec. 274(d) and new sec. 280F of the Code)[35]

Prior Law

Investment credit and cost recovery

A taxpayer generally may deduct ordinary and necessary expenses paid or incurred in carrying on a trade or business (sec. 162). Individuals also may deduct ordinary and necessary expenses paid or incurred for the production or collection of income (sec. 212). A deduction generally is not permitted for capital expenditures. However, depreciation deductions are allowed for certain property used in a trade or business or held for the production of income.

The cost of most tangible property placed in service after 1980 is written off under the Accelerated Cost Recovery system (ACRS) (sec. 168 of the Code). Under ACRS, each item of property is assigned to one of 6 recovery classes. For each class, ACRS provides both a recovery period (the number of years over which the costs may be written off), and a schedule of recovery percentages.

In general, new depreciable property (not including buildings) and a limited amount of used property are eligible for the investment tax credit. The credit is a specified percentage of the qualified investment. Generally, the regular investment credit is 10 percent; however, for 3-year property under the ACRS, such as automobiles, the credit is 6 percent.

For personal property, such as machinery and equipment, the recovery percentages corresponding to the most accelerated option available under ACRS approximate the benefits of using the 150-percent declining balance method (with a half-year convention) in the early years of the recovery period and the straight line method in the later years. For real property other than low-income housing, the recovery percentages approximate the benefits of using the 175-percent declining balance method in the early years and the straight-line method in the later years. The recovery deduction for an asset is computed by multiplying the cost of the property times the appropriate recovery percentage. For this purpose, the cost of personal property is first decreased by one-half the amount of the investment credit for the property (a basis adjustment), unless the taxpayer elects to take a reduced credit (sec. 48(q)). To determine earnings and profits for Federal income tax purposes, depreciation

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[35] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 166; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1387-1389; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 179; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 490-493; Senate floor amendment, 130 Cong. Rec. S. 4466-4467 (April 12, 1984); and H. Rep. No. 98-861 (June 23, 1984), pp. 1024-1032 (Conference Report).

of property in the 3-year or 5-year classes is generally computed by using the straight-line method (with a half-year convention) over 5 and 12 years, respectively, while depreciation of real property was computed using the straight-line method over 35 years under prior law.

As an alternative to cost recovery under ACRS, taxpayers may expense a limited amount of personal property that would otherwise qualify for the regular investment credit (sec. 179). No credit is allowed for costs which the taxpayer elects to expense under this option.

Depreciation deductions and the investment tax credit are available only with respect to the portion of the cost of an asset that is attributable to business use. Any use in a trade or business (sec. 162) or in connection with the production of income (sec. 212) qualified for purposes of determining the portion of the asset for which depreciation deductions and the investment credit were available.

A portion of the investment tax credit and expensing deduction may be recaptured if the portion of the asset attributable to business use declines after the first year it is placed in service. Under prior law, no such recapture rule applied to ACRS deductions.

Substantiation

Under prior law, the taxpayer was required to substantiate any deduction for travel expenses, entertainment, recreation, or gifts by adequate records or other evidence corroborating his own statements. These records were not required to be contemporaneous with the expense. Taxpayers who could reasonably reconstruct these expenses could be permitted to claim a deduction. These records were required to show the amount, time, place, and business purposes of the expense.

Reasons for Change

Congress believed that the investment incentives afforded by the investment tax credit and accelerated cost recovery should be directed to encourage capital formation, rather than to subsidize the element of personal consumption associated with the use of very expensive automobiles. The transportation necessary for conducting a business can be obtained from a luxury car or another car. To the extent an automobile is required for this necessary transportation, the generally allowable tax benefits should be available. Beyond that point, however, the extra expense of a luxury automobile provides, in effect, a tax-free personal emolument which Congress believed should not qualify for tax credits or acceleration of depreciation deductions because such expenditures do not add significantly to the productivity which these incentives were designed to encourage.

Congress was also concerned that many taxpayers claimed the advantage of the investment tax credit and accelerated depreciation with respect to automobiles and other property used primarily for personal or investment use rather than in the conduct of a trade or business. The incentives of the investment credit and ACRS were designed to encourage investment in new plant and equipment rather than to subsidize the purchase of personal property that is used incidentally or occasionally in the taxpayer's business. Therefore, Congress decided not to allow the incentive portion of tax benefits for property whose predominant use is personal or investment-related, rather than in the conduct of a trade or business.

Congress was also concerned that some taxpayers acquired automobiles and other property very late in the taxable year and claimed a very high percentage of business use for that portion of the year. Business use in subsequent years would often be minimal. Taxpayers could nonetheless claim full ACRS deductions for that first year and not be subject to recapture by reason of greatly diminished business use in the subsequent years.

In addition, Congress was concerned with significant noncompliance under prior law resulting from the overstatement of deductions and credits related to the business use of automobiles and other property that typically is used for personal purposes. Specifically, some taxpayers had attempted to convert personal use to business use through a variety of arguments, such as that an employee's "on-call" status or need to work late rendered any use a business use; or that signs, special paint, personalized license plates, or unique hood ornaments made the car a constant advertisement so that all use was business-related. Further, many taxpayers overstated the percentage of business use by after-the-fact, optimistic estimates of that use based on inexact recollection. The requirement of prior law that adequate records be kept was not observed uniformly. Thus, Congress believed that it is appropriate to require that contemporaneous records must be kept as a condition of claiming deductions with respect to this property.

Explanation of Provisions

a. Limitation on investment tax credit and depreciation for luxury automobiles

General rules

The Act limits the investment tax credit and accelerated depreciation available with respect to automobiles. Specifically, under the Act, the maximum investment tax credit that can be claimed with respect to any passenger automobile is $1,000, indexed for automobile price inflation between 1984 and the year the automobile is placed in service and rounded to the nearest $100. If the taxpayer elects a reduced investment credit in lieu of a basis adjustment for half the credit under section 48(q), then the maximum credit is two-thirds of maximum credit that could otherwise be claimed.

The maximum allowance for depreciation that can be claimed with respect to any passenger automobile is $4,000 in the year the automobile is placed in service by the taxpayer, and $6,000 in any subsequent year. Both figures are indexed for automobile price inflation between 1984 and the year an automobile is placed in service and rounded to the nearest $100. These limitations are applied after the investment credit, depreciation, and election to expense (sec. 179) are computed, but before reduction of the credit or depreciation to reflect the portion of an automobile's use that is personal use.

The $1,000, $4,000, and $6,000 limits for any year are reduced by the proportion of total use in that year that is personal use. If the limitation imposed on depreciation results in unrecovered basis existing after the otherwise applicable recovery period, then that basis may be recovered through an allowance for depreciation in subsequent years equal to the lesser of the unrecovered basis or $6,000, if the use of the automobile in those years is such that a deduction for depreciation is otherwise allowable. The deduction allowed under this rule is treated as a recovery deduction allowed under section 168 for purposes of the income tax.

The unrecovered basis of an automobile is the excess of the automobile's unadjusted basis over the amount of recovery deductions that would have been allowed during the recovery period if 100 percent of the automobile's use had been in a trade or business or for the production of income. For this purpose, an automobile is treated as a single property originally placed in service (i.e., the recovery period of which begins) in the taxable year in which it was acquired, notwithstanding any Treasury regulations prescribed under section 168(f)(7). Thus, to the extent that this provision disallows depreciation for any year (including the year the automobile is placed in service) because the limit on depreciation is reduced or no depreciation is allowed on account of personal use, this disallowed depreciation is not allowed in any subsequent year. Even if the taxpayer has minimal (or no) business use of the automobile for the first three years of ownership and then increases business use to the entire use of the automobile, the taxpayer is not treated as having placed in service upon the increase a new asset the basis of which is the original cost of the asset, reduced to reflect the previous minimal business use (if any).

Examples

The operation of this limitation may be illustrated as follows: Assume that on January 1, 1985, A purchases for $35,000 and places in service a passenger automobile which is 3-year recovery property under section 168. The automobile is used exclusively in A's trade or business. Assuming that no inflation adjustment applies to the $1,000, $4,000, and $6,000 limits, the amount of A's investment tax credit is limited to $1,000. A's unadjusted basis for ACRS purposes is $34,500 (i.e., $35,000 reduced by the one-half basis adjustment). A elects the use of the accelerated recovery percentages under ACRS. A's recovery deductions for the years during his recovery period (i.e., 1985 through 1987) are limited to $4,000, $6,000, and $6,000, respectively. A continues to use his car exclusively in his business during taxable years 1988 through 1991. For those years, A is limited to a recovery deduction of $6,000 per year. In 1991, A's recovery deduction is $500 (i.e., his unrecovered depreciable basis).

As another example, assume the facts are the same as in the prior example, except that trade or business use is 75 percent (rather than 100 percent) of total use in 1985 and 100 percent in all subsequent years. Under this provision, the investment credit would be $750 and depreciation for 1985 would be $3,000; these amounts are 75 percent of the otherwise allowable dollar limits. The recovery deduction in 1991 continues to be $500, even though total depreciation taken in prior years was $33,000. This is true because, for purposes of computing unrecovered basis under this provision, depreciation in 1985 is treated as having been $4,000, rather than $3,000, and the investment credit is treated as having been $1,000 rather than $750.

Definition of passenger automobile

For purposes of these limitations, a passenger automobile is defined as any 4-wheeled vehicle that is rated at 6,000 pounds gross vehicle weight or less and that is manufactured primarily for use on public streets, roads, and highways. The Act specifically excludes from the definition of a passenger automobile ambulances and hearses used directly in the taxpayer's trade or business, vehicles (such as taxicabs and limousines) used by the taxpayer directly in the trade or business of transporting persons or property for compensation or hire, and, under regulations, any truck or van.

This definition is substantively the same as that used for purposes of the gas guzzler tax (see sec. 4064(b)), except that there is regulatory authority to exclude from this new provision trucks or vans, whereas there is no regulatory authority to exclude trucks or vans from the gas guzzler tax. (Some trucks and vans, however, may be exempt from the gas guzzler tax because they were treated as nonpassenger automobiles under regulations issued by the Department of Transportation (see sec. 4064(b)(1)(B)). Thus, any passenger automobile (except a truck or van specifically excluded by Treasury regulations) subject to the gas guzzler tax is also subject to the investment tax credit and depreciation limitations of this provision.

Other rules

Ownership by multiple taxpayers.—All taxpayers who hold an interest in an automobile are treated as one taxpayer for purposes of applying the investment credit and depreciation limits. The limits are allocated among the taxpayers in proportion to their interests in the automobile.

Inflation adjustments.—As indicated above, the $1,000 limitation on the investment credit and the $4,000 and $6,000 limitations on depreciation are indexed for inflation. This adjustment is rounded to the nearest $100. This inflation adjustment allows for an increase in these limits annually, beginning in calendar year 1985. However, the adjusted limits for any year apply only to automobiles placed in service in that year; automobiles placed in service in prior years continue to be subject to the limits applicable to the year the automobile was placed in service. The amount of the inflation adjustment for any calendar year is the percentage of the limitation which is the same percentage by which the automobile component of the CPI for October of the preceding calendar year exceeds that component for October 1983. Thus, there is no adjustment for 1984; the first adjustment will apply to automobiles placed in service in calendar year 1985.

Leased automobiles.—The limits do not apply to an automobile leased or held for leasing by any person regularly engaged in the business of leasing automobiles. Rather, the limits are applied to the lessee by denying a deduction for the percentage of the lease payments that is substantially equivalent to the placing of these restrictions on the lessor. This percentage is to be determined under tables prescribed by the Treasury. If the lessor passes through the credit to the lessee, the limit on the investment credit allowable applies to the lessee.

Regulations.—The Act provides the Treasury with authority to prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section. These regulations should, among other things, ensure that taxpayers cannot evade the restrictions on the investment credit and depreciation by, for example, separating an automobile into its component parts. The Treasury is given explicit authority to include or exclude items from the adjusted basis of any listed property.

b. Personal use of automobiles and other property

Overview

For automobiles and other specified property ("listed property") that is not used predominantly in a trade or business, the Act provides new limitations on the availability of the investment tax credit, accelerated capital cost recovery and the expensing election. Under these rules, the investment credit and the expensing election are not available and depreciation must be computed under the straight-line method using a specified life longer than the ACRS recovery period if use for personal purposes or the production of income (as opposed to trade or business use) constitutes 50 percent or more of the property's use.

Listed property

Listed property is defined as (1) any passenger automobile (as defined above); (2) any other property used as a means of transportation; (3) any property of a type generally used for purposes of entertainment, recreation, or amusement; (4) any computers or peripheral equipment; and (5) any other property of a type specified in Treasury regulations. However, listed property does not include, and this provision consequently does not apply to, any computer exclusively located at a regular business establishment (including a qualifying home office) of the employer or proprietor and owned by or leased to the employer or proprietor. (Prior law rules permitting the credit and deduction only with respect to the business use of these computers in a trade or business or for the production of income still apply.)

Qualified business use

Under the Act, the investment tax credit, the accelerated percentages and shortened lives of ACRS, and the expensing election are not available with respect to listed property unless the "qualified business use" of the listed property during the taxable year exceeds 50 percent of the total use of the property. With certain exceptions (described below), qualified business use consists of use in a trade or business. Use in the production of income (rather than a trade or business) is not qualified business use. The 50-percent test is computed on an asset by asset basis, based on the usage of each individual asset.

The definition of qualified business use applies only to determine whether the 50-percent test is satisfied. Once the availability of the investment credit and the accelerated percentages and shortened lives of ACRS or expensing has been determined, however, the proportion of total use for which depreciation is allowed generally is determined according to prior law rules, which allow any trade or business use, as well as use for the production of income, to be taken into account for this purpose.

Use by 5-percent owners.—For purposes of this rule, qualified business use does not include the leasing of property to any 5-percent owner of the taxpayer or to any person related to a 5-percent owner. Similarly, use of property to provide compensation for the performance of services by a 5-percent owner or a related person does not constitute qualified business use. These uses of listed property are not qualified business use whether or not the 5-percent owner or the related person includes that value in his income, or, where otherwise required, the value was reported and withheld upon on the person's Wage and Tax Statement (Form W-2).

A 5-percent owner is any natural person who is a 5-percent owner with respect to the taxpayer within the meaning of section 416(i)(1)(B)(i) (defining key employees for purposes of the top-heavy rules). Thus, a 5-percent owner is, in the case of a corporate taxpayer, any person who owns (or who is treated under section 318 as owning) more than 5 percent of the outstanding stock of the corporation or stock possessing more than 5 percent of the combined voting power of all stock of the corporation. If the taxpayer is not a corporation, a 5-percent owner is any person who owns more than 5 percent of the capital or profits interests in the trade or business. A related person is any person related to a 5-percent owner within the meaning of section 267(b).

For airplanes and helicopters, compensation or leasing to 5-percent owners and related taxpayers is qualified business use, provided that qualified business use without consideration of those activities is at least 25 percent of total use.

Use by persons other than 5-percent owners.—The personal use of listed property by persons other than 5-percent owners (such as employees) is not treated as qualified business use unless the fair market value of the use is included in the person's income and, where otherwise required, the value was withheld upon and reported on the person's Wage and Tax Statement (Form W-2). If wage withholding is not required with respect to that person, then other reporting requirements may require that the fair market value of the use is to be reported on the Statement for Recipients of Miscellaneous Income (Form 1099-Misc.) Thus, for persons other than 5-percent owners, use of listed property provided as compensation for the performance of services, if included in income, and, if required, reported as miscellaneous income or reported and withheld upon on the wage withholding statement, is considered qualified business use for purposes of determining the method of depreciation that may be used.

50-percent test.—If qualified business use for an item of listed property does not exceed 50 percent of total use for the current year or any prior year, the investment credit is not allowed and cost recovery for the portion of the use for which depreciation deductions are allowed must be computed on a straight-line basis (using a half-year convention (except for 18-year real property) and without regard to salvage value) using earnings and profits lives (see sec. 312(k)(3)(A)). With respect to 3-year property (such as automobiles), this is a 5-year period. With respect to 5-year property (such as computers or transportation equipment other than automobiles), it is a 12-year period. With respect to real property, it is generally a 40-year period.

Similarly, if qualified business use falls below 50 percent in any subsequent year, the listed property will be treated as disposed of and investment credit recapture will occur as provided in prior and present law (see sec. 47(a)(5)). With respect to recapture of the investment credit, any property (or portion thereof) which ceases to be section 38 property during a taxable year, other than because of a disposition, is considered to be disposed of on the first day of the taxable year (Treas. reg. secs. 1.47-1(c), 1.47-2(e)). Congress expected that these regulations will be strictly enforced. Congress noted that the Treasury can provide, as has been done in other areas, a rule that a de minimis reduction in the portion of property that continues to be section 38 property will not trigger any recapture.

Further, under the Act, a reduction in the qualified business use portion from above 50 percent to 50 percent or below in any year triggers recapture of excess depreciation. Excess depreciation is the excess of depreciation allowable in prior years (whether under ACRS or an election to expense (see sec. 179)) over depreciation that would have been allowable on the basis of the earnings and profits life and the straight-line method without the section 179 expensing election.

Any deduction allowable because of an election (under sec. 179) to expense any listed property is treated as if it were a depreciation deduction under ACRS. Therefore, if qualified business use (i.e., use in a trade or business, not use for the production of income) does not exceed 50 percent, the taxpayer may not make an election to expense, but rather must depreciate the listed property on a straight-line basis using earnings and profits lives.

Under ACRS, taxpayers may elect, in lieu of the prescribed accelerated percentages, an optional recovery method. The taxpayer may elect either percentages based on the straight-line method for the regular recovery period or one of the two optional longer recovery periods. Generally, an election to use an optional recovery method must be made in the year the property is placed in service by the taxpayer. Additionally, except in the case of 18-year real property, a taxpayer who elects to use an optional recovery method must elect the same recovery method for all property of that class placed in service in the year for which the election is made. The mandatory use of the straight-line method under this new provision is not intended to have any effect on other recovery property of that class placed in service in the same year by the taxpayer. Thus, a taxpayer who owns a car that is subject to this provision and which must be recovered over a 5-year recovery period has not made a binding election with respect to all other 3-year recovery property placed in service in the same taxable year.

Other rules

Allowable portion of investment credit and depreciation deductions.—As stated above, the qualified business use percentage is used only to determine eligibility for the investment credit and the method of depreciation that may be used (i.e., either the accelerated percentages and shortened lives of ACRS or the straight-line method using earnings and profits lives). The qualified business use percentage is not used to determine the amount of depreciation that can be claimed after the method of depreciation has been determined. The amount of depreciation that can generally be claimed when the property is used partly for personal purposes is determined under the principles of prior law, which is generally unchanged. Thus, use for the production of income and for all compensation provided for services may be considered in determining the amount of depreciation that may properly be claimed. Such use may also be used to determine the amount of the investment credit, so long as the qualified business use percentage exceeds 50 percent. For example, if a specified asset is used 30 percent in a trade or business and 30 percent for the production of income, the taxpayer may not claim the investment credit or ACRS and must instead compute depreciation on a straight line basis using the earnings and profits recovery period, claiming 60 percent of the depreciation allowable under this method. If, however, an asset not used for providing compensation is used 70 percent in a trade or business and 20 percent for the production of income, the taxpayer may claim the investment credit and ACRS based on 90 percent business use.

To facilitate the interpretation of prior law, Congress expected that the Treasury will issue regulations that provide explicit methods for allocating basis between business and personal use. With respect to automobiles, the regulations could provide that the proportion of business use is not to be greater than the proportion of total mileage which is driven for business purposes. The Treasury may also provide alternate means to determine the business use percentage for automobiles. For example, regulations could provide that, regardless of the proportion of total miles incurred in business, if an automobile is used 5 days a week for business purposes and is available 2 days a week for personal purposes, in no event may the taxpayer consider more than five-sevenths of the use to be allocable to business purposes. An allocation based on different factors, such as time, may be more appropriate for other types of property.

Commuting is not use in a trade or business or for the production of income, regardless of whether work is performed during the trip. Thus, for example, a business telephone call on a telephone installed in an automobile made while the taxpayer is commuting to work does not transform the character of the trip from commuting to business. This is also true for a business meeting held in a car while the taxpayer is commuting to work. Similarly, a business telephone call made on an otherwise personal trip does not transform the character of the trip from personal to business. In a likewise manner, the fact that an automobile is used to display material that advertises the owner's or user's trade or business does not convert an otherwise personal use into business use.

As under prior law, when the use of property owned by an employer is provided as compensation to an employee, the employer's deduction with respect to this property is the depreciation deduction allowed under section 167 with respect to this use. The provision of the use of this property as compensation does not permit a deduction for compensation under section 162, with respect to the employer's basis in the property, in addition to the deduction allowed under section 167.

Entertainment, amusement, and recreation facilities.—As was provided under prior law, a taxpayer is generally entitled to no depreciation deduction with respect to an entertainment, recreation, or amusement facility. If, however, the taxpayer is otherwise permitted to take a depreciation deduction with respect to one of these facilities (such as a gymnasium or a hunting lodge), then the taxpayer is subject to the restrictions of this provision. Thus, for example, if qualified business use of the facility does not exceed 50 percent, then the taxpayer must depreciate the facility on a straight-line basis over the earnings and profits life. As explained above, if the facility is used by persons other than 5-percent owners, qualified business use does not include use for providing compensation unless the fair market value of their use is included in their income and, if required, is either reported on the Statement for Recipients of Miscelleneous Income (Form 1099-Misc.) or is reported and withheld upon on the person's Wage and Tax Statement (Form W-2).

Standard mileage rate.—In lieu of any depreciation or expensing deduction, the taxpayer may elect, as under prior law, to compute his deduction for the business use of his automobile at the standard mileage rate, as determined by the Internal Revenue Service. This rate is currently 20.5 cents a mile for the first 15,000 miles of business use per year, up to a maximum of 60,000 miles. Beyond those limits, the rate is 11 cents per mile. This election remains available regardless of whether qualified business use does or does not exceed 50 percent. As under prior law, the taxpayer may claim the investment tax credit when using the standard mileage rate (see Rev. Rul. 67-348); however, the $1,000 limit (adjusted for inflation) now applies. The taxpayer may only do so, however, if the qualified business use of the automobile (i.e., use in a trade or business, not use for the production of income) exceeds 50 percent.

Leased property

Reduction or denial, due to personal use by the lessee, of the investment tax credit, the accelerated percentages and shortened lives of ACRS, and expensing does not apply to lessors. Personal use by the lessor does, however, cause a reduction in the available investment credit and depreciation. Lessees are denied a deduction for a percentage of the lease payment that is substantially equivalent to the value of the portion of the investment tax credit and depreciation and expensing deductions which would have been denied due to personal use. This percentage is to be prescribed in tables issued by the Treasury. These tables may be coordinated with the tables to be prescribed denying a deduction for a percentage of the lease payment attributable to the effect of the caps on the investment credit and depreciation. The rules for determining the term of a lease that apply in ACRS also apply in this provision.

The Treasury is also required to prescribe regulations providing for a recapture of the portion of the lease payments that represents excess depreciation when qualified business use (i.e. use in a trade or business, not use for the production of income) decreases from above 50 percent to 50 percent or below in any year. Excess depreciation is the excess of depreciation allowable (whether under ACRS or an election to expense) over depreciation that would have been allowable on the basis of the earnings and profits life and the straight-line method.

Employee deductions for listed property

If an employee owns or leases listed property which is used in connection with his employment, no investment credit, depreciation deductions, or deductions with respect to lease payments are available under the Act with respect to such use unless the use of the property is required for the convenience of the employer and as a condition of employment.

Congress intended the terms "convenience of the employer" and "condition of employment" to have the same meaning with respect to this provision as they do with respect to the exclusion from gross income for lodging furnished to an employee (see sec. 119). To satisfy the condition of employment requirement, the use of the property by the employee must be a necessary prerequisite for the employee to properly perform the duties of his employment. This requirement is not satisfied merely by an employer's statement that the property is required as a condition of employment. Congress intended that the principles of *Dole* v. *Commissioner*, 43 T.C. 697, *aff'd*, 351 F.2d 308 (1st Cir. 1965), apply.

Examples

The following examples illustrate the operation of this provision.

Example 1.—On August 1, 1984, B corporation purchases for $25,000 and places in service a passenger automobile which is 3-year recovery property under section 168. C owns 100 percent of B corporation. The automobile is used 25 percent in B's business and 75 percent for C's personal use for years 1984 through 1989. Assume for purposes of this example that B includes in C's W-2 the fair market value of C's use. Because C is a 5-percent owner of B, C's use does not count as qualified business use, even though the fair market value is included on C's W-2. Consequently, B may not claim the investment tax credit and must use either the straight-line method over 5 years or the longer recovery period of 12 years, which B may elect under section 168(b)(3). B uses the 5-year period. Since the provision of the car to C has been treated as compensation, B may claim 100 percent of the potentially allowable depreciation. In 1984, B's recovery deduction is $2,500, i.e., 1.00 (business use) x $25,000 x .10 (depreciation on a straight line basis with a half-year convention). In 1985 through 1988, B's recovery deduction is $5,000 (i.e., 1.00 x $25,000 x .20). In 1989, B's recovery deduction is $2,500 (i.e., 1.00 x $25,000 x .10). No further recovery deductions are available to B.

Example 2.—On December 1, 1984, A purchases for $30,000 and places in service a passenger automobile which is 3-year recovery property under section 168. A owns 100 percent of his unincorporated business. In 1984, A uses his car 40 percent in his business, 20 percent in an investment activity, and 40 percent for personal purposes. Because A does not use his car more than 50 percent in his trade or business, A may not claim an investment tax credit with respect to the car. A's unadjusted basis is $30,000. Also, because A does not use the car more than 50 percent in his trade or business (i.e., in a "qualified business use"), the deduction allowed under section 168 must be determined by use of the straight-line method over a 5-year recovery period (or, if A so elects, over a 12-year period). A's allowable depreciation deduction is determined by multiplying the maximum allowable depreciation of $3,000 ($30,000 x 10%), which is less than the $4,000 cap, times the ordinary business use percentage (60%).

Example 3.—On July 1, 1984, A purchased for $18,000 and placed in service a passenger automobile which is 3-year recovery property under section 168. A's 1984 qualified and ordinary business use percentage is 80 percent. A elects to take a reduced investment tax credit in lieu of a basis adjustment. The amount of A's investment tax credit is limited to $533.33 (i.e., $1,000 x 2/3 (which is less than .04 x $18,000) times 80% business use). A selects the use of the accelerated recovery percentages under ACRS. A's unadjusted basis for ACRS purposes is $18,000. A's 1984 recovery deduction is $3,200 (i.e., $4,000 (which is less than $18,000 x .25) times 80% business use). In 1985, A's business use percentage is 80 percent. A's 1985 recovery deduction is $4,800 (i.e., $6,000 (which is less than $18,000 x .38) times 80% business use).

In 1986, A's qualified and ordinary business use percentage is 45 percent. As a result of the decline in business use percentage, A, for investment tax credit purposes, is treated as having disposed of the automobile on January 1, 1986, and must recapture a portion of the investment tax credit claimed previously (pursuant to Treas. reg. secs. 1.47-1(c), 1.47-2(e)). A's investment credit recapture is $352.00 (i.e., $533.33 x .66 (the percentage specified in sec. 47(a)(5))). Since A's business use is not greater than 50 percent, A must recompute (for recapture purposes) his recovery deductions for the preceding recovery years using the straight line method over 5 years and make corresponding adjustments to basis. A's recomputed recovery deductions for 1984 and 1985 are $1,440 (i.e., .10 x $18,000 x .80), and $2,880 (i.e., .20 x $18,000 x .80), respectively. A must recapture excess depreciation of $3,680 (i.e., (3,200 + 4,800)-(1,440 + 2,880)) and include that amount in gross income as ordinary income for 1986. A's recovery deduction for 1986 is $1,620 (i.e., $18,000 x .20 (which is less than $6,000) times 45% business use).

A's business use for 1987 and 1988 is 45 percent and his recovery deduction for each year is $1,620. In 1989, A's business use is 45 percent and his recovery deduction is $810 (i.e., $1,800 x .45). A may not recover any additional amounts, because had he used the automobile solely for business purposes, he would have recovered his entire unadjusted basis (i.e., $18,000) by 1989.

Example 4.—The facts are the same as in Example 3, except that A's qualified business use percentage after 1985 is 60 percent, rather than 45 percent. A's investment credit recapture is $88.00 (i.e., (.80 -.60) x ($1,000 x 2/3) x .66). There is no recapture of depreciation.

c. Recordkeeping and compliance

The Act provides that taxpayers are required to substantiate by adequate contemporaneous records, i.e., records created at the time of the expense, any tax credit or deduction (1) with respect to the business use of listed property, (2) with respect to traveling expenses (including meals and lodging while away from home), (3) for any item with respect to an activity that is of a type generally considered to constitute entertainment, amusement, or recreation, or with respect to a facility used in connection with such an activity, and (4) for any expense for gifts. However, it was not intended that these recordkeeping requirements were to apply to the extent that the expense or the use of listed property is provided as compensation and that the employer complies with withholding and reporting requirements applicable to such compensation.

If the taxpayer does not have adequate contemporaneous records, no credit or deduction is allowed with respect to that item. If, however, adequate contemperaneous records were made but then were lost due to circumstances beyond the taxpayer's control, such as a fire, flood, or earthquake, Congress intended that taxpayers continue to have the ability, as under prior law, to substantiate a deduction by reasonable reconstruction of expenditures (see Treas. reg. sec. 1.274-5(c)(5)).

Congress expected that the contemporaneous records required to be kept by this provision of the Act must reflect with substantial accuracy the business use of the property. The records must indicate the business or personal purpose of the expense or use, unless the business purpose is clear from the surrounding circumstances. With respect to automobiles, contemporaneous logs recording the date of the trip and the mileage driven for business purposes must be kept, whether or not the automobile is used for overnight travel.

The Act requires that a return preparer properly and fully advise the taxpayer of these contemporaneous recordkeeping requirements and also must obtain written confirmation from the taxpayer certifying that adequate contemporaneous records supporting these deductions and credits exist. If the return preparer does not obtain this written certification, the preparer is subject to a penalty. Congress anticipated either that the content of this certification will be specified by the Treasury or that the Treasury will prescribe a form for this certification. Congress expected that the Treasury will amend Form 2106 or any other appropriate form to require that the taxpayer directly indicate on his return whether the required records have been kept. This could be done, for example, by providing a box to check on the return.

The Act also provides that any portion of an underpayment of tax attributable to a failure to comply with these contemporaneous recordkeeping requirements is treated as due to negligence, for purposes of the penalty on underpayment of tax, in the absence of clear and convincing evidence to the contrary. Claiming a deduction or credit without the support of the required records may also be fraud for purposes of this penalty. This is in addition to the loss of the credit and deduction that would occur.

Congress anticipated that the Treasury will draw the attention of taxpayers to these new recordkeeping requirements in the appropriate regularly issued Internal Revenue Service publications. To accomplish this, for example, the Service could describe these new recordkeeping requirements in the section of the instructions to the 1984 Form 1040 that highlights important tax law changes.

Effective Date

The limits on the investment tax credit and depreciation are effective for property placed in service by the taxpayer or leases entered into by the taxpayer after June 18, 1984. However, property acquired by the taxpayer pursuant to a binding contract in effect on or before June 18, 1984, that is placed in service by the taxpayer before January 1, 1985, is not subject to these limits.

The provisions relating to a personal use property are effective for property placed in service by the taxpayer after June 18, 1984. However, property acquired by the taxpayer pursuant to a binding contract in effect on or before such date which is placed in service by the taxpayer before January 1, 1985 (or January 1, 1987, in the case of real property) is not subject to these provisions.

The recordkeeping and compliance provisions are effective for taxable years beginning after 1984, regardless of the year that the property was placed in service by the taxpayer. Thus, for example, if the owner of a business placed an automobile in service in 1981 for use in the business, the owner may claim, in taxable year 1985 and all following years, a deduction for only that portion of the use of the automobile with respect to which he has kept adequate contemporaneous records (i.e., logs) of business use.

Revenue Effect

These provisions are estimated to increase fiscal year budget receipts by $48 million in 1984, $150 million in 1985, $233 million in 1986, $269 million in 1987, $279 million in 1988, and $286 million in 1989.

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TITLE II—LIFE INSURANCE TAX PROVISIONS

A. Prior Law

1. Pre-1959 Taxation of Life Insurance Companies

Before 1921, insurance companies were taxed in substantially the same manner as other corporate entities. Under the Revenue Act of 1921 and subsequent legislation, however, life insurance companies were accorded special tax treatment.

From 1921 through 1957, a life insurance company was only taxed on investment income. Premiums were excluded from the income computation, as were losses and expenses incurred in underwriting operations, and gains and losses from the sale of investment assets. In addition, various formulas were established to exclude from taxation the portion of investment income necessary to satisfy the company's obligations to policyholders under its insurance contracts. Although the formulas varied from time to time, their purpose was always to compute that portion of investment income allocable to policyholders. This approach of taxing income only to the extent not needed to fund current and projected liabilities to policyholders as determined under State law has been referred to as taxing a company on its free investment income.

2. The 1959 Act

In general

The general framework under which life insurance companies were taxed under prior law was adopted in the Life Insurance Company Income Tax Act of 1959 (secs. 801-820 of the Code).[1] The 1959 Act significantly changed prior law by attempting to measure the total income of a life insurance company rather than just its free investment income. Nonetheless, as described below, under the 1959 Act various deductions and "special rules" resulted in an income tax base which fell short of total income.

Computing taxable income

Under the 1959 Act, a life insurance company was taxed on the lesser of its taxable investment income or its gain from operations. If a company's gain from operations exceeded its taxable investment income, the company was taxed on 50 percent of such excess. The tax with respect to the other half of the excess of gain from operations over taxable investment income was deferred; that half (along with amounts deducted for nonparticipating contracts, accident and health and group life insurance contracts) was added to a

[1] Public Law 86-69, June 25, 1959. The Act was generally effective for taxable years beginning after December 31, 1957.

deferred tax account (policyholders' surplus account) and, subject to certain limitations, was taxed only when distributed to shareholders of a stock company.[2] Thus, under the 1959 Act, a life insurance company computed its gain (or loss) from operations and its taxable investment income. The computation of gain from operations began with the company's total income, including the company's share of investment yield,[3] net capital gain, premiums and other considerations, decreases in insurance reserves, and all other amounts. From this total, a life insurance company was allowed deductions. These generally included the usual deductions available to taxpayers for business or investment expenses, an operations loss deduction, and certain deductions unique to the insurance business such as for payments of claims and death benefits, for increases in reserves (to the extent not funded out of the policyholders' share of investment income), and for certain payments under assumption reinsurance. All life insurance companies were also permitted to claim a small business deduction. Finally, there were three special deductions for policyholder dividends, nonparticipating contracts, group life insurance, and accident and health contracts, which were subject to limitations. Unlike the deduction for policyholder dividends, the other two special deductions did not reflect actual cash expenditures by the company or even the commitment of funds to a reserve required under State law.

In addition, a deduction was allowed for the company's allocable share of tax-exempt income and the amount of any dividends received by the company that were deductible under provisions generally applicable to all corporations. The initial inclusion of tax-exempt income, followed by the later deduction of the company's share, had the effect of allocating a portion of tax-exempt income to the policyholders' share which was not includible in the company's taxable income in any event. Thus, tax-exempt income was not as attractive to life insurance companies as to other taxpayers as a means of reducing their effective tax rate.

To compute taxable investment income, it was necessary to calculate investment yield. Investment yield was the excess of gross investment income over all applicable investment expenses. Then, the policyholders' share of investment yield was excluded.[4] Finally, the company deducted from its share of investment yield its share of tax-exempt investment income and of the deduction for dividends received.

Under the 1959 Act, the computation of a life insurance company's taxable investment income was important for two purposes.

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[2] Typically, this will be incurred only if a company is acquired and liquidated to achieve an increase in the basis of its assets.

[3] The computation actually begins with gross investment income, less investment expenses, from which the interest contractually required to be set aside for policyholders is excluded. A portion of an item required to be set aside for policyholders is referred to as the policyholders' share of such item. The excess of the amount of the item over the policyholders' share is the company's share.

[4] Under the taxable investment income computation, the policyholders' share of investment yield is determined in part by use of the "Menge formula," which arithmetically adjusts State-required life insurance reserves to allow the crediting of earnings at an adjusted rate that takes into account the actual earnings rate of the individual companies. In general, the effect of this computation is to allocate to the policyholder an amount at least equal to the reserves required under State law (unless under the permanent provisions, the current earnings of the company exceed 10 percent). The 1959 Act does not establish a Federal standard for computation of reserves or require that they be based on a company's actual experience.

First, as discussed above, a company could be taxed on its taxable investment income. Second, for purposes of computing gain from operations, the aggregate amount allowed for the special deductions was limited by reference to the amount of the company's taxable investment income. Prior to amendment in the Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248) (TEFRA), the 1959 Act provided that the amount of deductions allowed for policyholder dividends, for nonparticipating contracts, and for accident and health and group life insurance contracts be limited to the amount by which gain from operations (before those deductions) exceeded taxable investment income, plus $250,000. This limitation was designed to ensure that most large companies be subject to tax at least on their free investment income (reduced by no more than $250,000). As explained below, this $250,000 statutory amount was modified in TEFRA.

Tax phases

The provisions described above for computing a life insurance company's taxable income required a comparison of the company's taxable investment income and its gain from operations. Depending on the mix of these elements, two companies with the same aggregate pre-tax income could owe different amounts of tax. The result was that most life insurance companies were classified on the basis of the mix of investment income and underwriting gain as being in one of three tax categories.

Phase I Company

Under the 1959 Act, a Phase I company had a gain from operations that was less than its taxable investment income by $250,000; it had reached the limit on the special deductions. A life insurance company that would typically have been in this phase was an established mutual company, which might have substantial underwriting income before any policyholder dividend distributions. This company could use the deduction for policyholder dividends to reduce gain from operations.

Phase II (Positive) Company

A Phase II (Positive) company had a gain from operations in excess of its taxable investment income, taking into account any policyholder dividends. A typical life insurance company taxed under this phase was an established stock company that had no State law requirement to share favorable investment and underwriting experience with its policyholders through policyholder dividends. A Phase II (Positive) company's taxable income was generally the sum of its taxable investment income, and one-half of the excess of its gain from operations over taxable investment income. Because a company's gain from operations was roughly the sum of its taxable investment income and its underwriting gain, a Phase II (Positive) company was taxed currently on one-half of its underwriting gain while the other half became part of the policyholders' surplus account (known generally as the Phase III account).

Phase II (Negative) Company

A Phase II (Negative) company had a gain from operations less than its taxable investment income by more than $250,000 (under the 1959 Act) because of underwriting losses. Typically, a Phase II (Negative) company was a new or growing stock life insurance company that had underwriting losses because of high start-up costs associated with new insurance business. In such a case, taxable investment income was reduced by the expenses of operating the company because the underwriting income alone was not sufficient to cover the costs of the insurance business. A Phase II (Negative) company's taxable income was its entire gain from operations.[5]

3. TEFRA Changes

In TEFRA, Congress addressed certain tax avoidance techniques available to life insurance companies through both permanent provisions and temporary provisions (effective, generally, for 1982 and 1983). The latter allowed a more thorough Congressional review of the tax laws applicable to life insurance companies and their products.

Modco and other reinsurance

Provisions governing modified coinsurance transactions were permanently repealed. In addition, provisions were adopted to prevent abuse through dividend reimbursement agreements between insurance companies engaged in reinsurance transactions. Further, provisions were added to deny deductions for interest paid on indebtedness used in reinsurance transactions, and to grant Treasury special income allocation and recharacterization authority with respect to reinsurance transactions between related parties. TEFRA provided, in addition, that for years before 1982 (except in the case of fraud) the determination of whether a reinsurance contract satisfied the modified coinsurance requirements of then existing law would be made solely by reference to the terms of the contract.

Special deductions

TEFRA provided a temporary change in the limitation on the special deductions for policyholder dividends, nonparticipating contracts, accident and health and group life insurance contracts. This provision generally raised the $250,000 statutory dollar amount under the 1959 Act to $1 million, but targeted it to small life insurance companies.

TEFRA also provided an alternative limitation on the special deductions. Under this provision, the maximum amount that could be deducted was the sum of (1) 100 percent of policyholder dividends on pension contracts, (2) the statutory amount, and (3) 85 percent (77½ percent for mutual companies) of the tentative deduction for policyholder dividends, other than policyholder dividends on pen-

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[5] In addition to the three tax categories discussed above, there was also a "Phase I Corridor" company, which was taxed on its entire gain from operations that was less than taxable investment income by an amount less than $250,000 (under the 1959 Act), and a "Phase III" company, which had taxable income that included shareholder distributions of, or subtractions from, previously tax-deferred amounts from the policyholders' surplus account.

sion business. For most companies, this alternative was substantially more generous than the limitation provided under the 1959 Act.

Computation of reserves

TEFRA contained a number of temporary provisions relating to the computation of reserves. First, interest guaranteed in a contract in excess of the interest that would be earned at the rate assumed for purposes of computing statutory reserves could not be taken into account in computing the reserves to the extent such excess interest is guaranteed beyond the taxable year. Second, under TEFRA, the amount of investment yield that could be allocated to group pension contracts was limited to the amount actually credited to such contracts. Both of these provisions had the practical effect of reducing the exclusion for the policyholders' share of investment yield. Third, under TEFRA, the status of a life insurance company could not be changed because of its reserve treatment of group pension funds. This prevented reclassification for tax purposes of life insurance companies as casualty insurance companies—which would be adverse to certain stock companies and favorable for certain mutual companies—because they had removed life contingencies from pension contracts. Fourth, an arithmetic adjustment to reserves contained in the 1959 Act (the Menge formula) was changed to a geometric adjustment, allowing a slightly more generous policyholders' share of investment yield. In addition to these temporary changes, there was a permanent reduction in the amount allowed a life insurance company under the approximate formula for revaluing preliminary term reserves for insurance other than term life insurance. Under TEFRA, reserves were increased by $19 per $1,000 of insurance in force and reduced by 1.9 percent of the reserves (rather than by $21 per $1,000 reduced by 2.1 percent, as under pre-TEFRA law).

Consolidated returns

Under a temporary provision, related life insurance companies were allowed to compute their respective taxable incomes before consolidation (a bottom-line method). This method was allowed instead of requiring consolidation of income items before computing consolidated taxable income (a phase-by-phase method).

Annuities

TEFRA also contained permanent changes for the tax treatment of annuity contracts to companies and to policyholders. In general, companies were allowed the full deduction for amounts credited to annuity contracts. For a policyholder, cash distributions from an annuity contract before the annuity starting date were taxable to the policyholder to the extent there was income in the contract. Also, if a portion of such an income distribution was attributable to an investment in the contract that was made within 10 years of the distribution, there was a 5-percent penalty tax on such portion. There were, however, a number of exceptions to this rule; for example, no penalty applied to income distributions on or after the policyholder reaching age 59½.

Flexible premium life insurance

Finally, TEFRA adopted temporary guidelines with respect to flexible premium life insurance contracts (i.e., universal life and adjustable life), which had to be met in order for the death proceeds from such contracts to be considered life insurance for tax purposes.

B. Reasons for Change

Overview

The changes in the tax treatment of life insurance companies, life insurance and annuity products, and policyholders in the Act were motivated primarily by two concerns. The first concern was the need to adjust the taxation of life insurance to reflect the unusually large increase in interest rates that had occurred since 1959. The second was the desirability of simplifying the Code and eliminating the extraordinarily complex three-phase tax structure of present law.

Rising interest rates had caused several changes in the tax position of life insurance companies since the enactment of the 1959 Act. First, with investment income increasing because of rising interest rates, the tax liability of mutual (and, to a lesser extent, stock) insurance companies began to increase. Second, these companies made extensive efforts to reduce their increasing Federal income tax liability by entering into larger volumes of modified coinsurance transactions by which investment income was recharacterized as underwriting income. In 1981, one of the largest mutual companies used modified coinsurance so extensively that it reduced its tax to zero. Third, some stock companies, in order to compete with other financial intermediaries, began to offer investment-oriented products that, in effect, allowed them to distribute currently high investment yields tax-free to policyholders. Mutual companies were slower to enter this market because their ability to pay policyholder dividends already permitted them to pass through to policyholders favorable investment experience, although some of those dividends were taxed at the company level because of the limitation on the deduction for policyholder dividends.

In 1982, the Congress responded to these changes in the life insurance industry through a number of tax changes, including a permanent repeal of the provisions for the special tax treatment of modified coinsurance. At that time, it was estimated that the repeal of the special tax provisions for modified coinsurance would increase revenues by $2.3 billion in 1982 over an estimated prior law tax burden of $1.7 billion. Concern over the effect of so substantial a change in tax burdens led to enactment of a series of temporary provisions which generally had the effect of reducing the industry tax burden by an estimated $1.2 billion for 1982 and by the same amount for 1983. These provisions expired at the end of 1983.

Inadequacies of the 1959 Act

In reviewing the 1959 Act, the Congress identified numerous inadequacies. First, drafted in the middle of a period of low and stable interest rates, the 1959 Act distinguished between investment and underwriting income and taxed them differently. While interest rates remained stable, the 1959 Act functioned reasonably well, although it never taxed companies on their full economic income. With increases in interest rates and the evolution of new insurance products, however, the 1959 Act resulted in an inappropriate measure of life insurance company income. As a result, the Congress concluded that a proper measure of the income of life insurance companies can be obtained only by replacing the complex, three-phase structure of present law with a simpler, single-phase tax.

A second inadequacy of the 1959 Act was that the Act included a variety of deductions and deferral items that did not relate to a proper measure of a life insurance company's income and which provided extraordinary benefits for some companies and no benefits for other companies. In particular, the special deductions for group life and accident and health insurance and for nonparticipating policies bore no relationship to actual expenditures by companies and tended to benefit mature stock companies more than other companies. Similarly, the deferral of tax on underwriting income was, in effect, beneficial only to certain stock life insurance companies. The revaluation of reserves from amounts computed under a preliminary term method to amounts computed under a net level premium method allowed a deduction for amounts that were not, in fact, added to reserves and benefited expanding, newer, stock life insurance companies. Finally, the rules relating to deduction of policyholder dividends, which primarily affect mutual companies, operated to assure that companies were taxed on at least their investment income. These rules did not attempt to distinguish between amounts returned to policyholders as customers and amounts distributed to them as owners of the mutual company. As a result, a mutual company might have been taxed on a base that was either greater than or less than its economic income.

A third concern with respect to the 1959 Act related to the tax treatment of reserves maintained by life insurance companies. Under prior law, a company's reserves were based on its statutory reserves, which were computed using assumptions under State law. The result was a significant overstatement of liabilities in comparison to those measured under realistic economic assumptions. The Congress concluded that a more accurate measure of liabilities for tax purposes can be achieved by imposing specific rules for the computation of tax reserves that result in a reserve which approximates the least conservative (smallest) reserve that would be required under the prevailing law of the States.

A fourth concern was a significant shifting of tax toward the mutual company segment of the industry. As interest rates rose, investment income became an increasingly large portion of life insurance company income. Many stock companies could offset at least a portion of this income with losses generated by their underwriting activities. Mutual companies, on the other hand, generally charge higher premiums for their products and are less likely to have underwriting losses. Thus, with the permanent repeal of the provisions governing modified coinsurance transactions, there might have been a significant shifting of tax under the 1959 Act toward mutual companies.

Single-phase tax

The single-phase tax contained in the Act was designed by reference to a stock life insurance company model. This choice was made because it provides a relatively simple tax structure for life insurance companies that bears a close resemblance to the general structure of corporate income taxation. Further, the choice of the stock company model reflected the view that life insurance is primarily a commercial activity, and that no company should engage in it without being subject to Federal corporate income taxes.

In redesigning the statutory scheme for taxation of life insurance companies, the Congress was concerned that the new provisions not unduly prejudice companies by suddenly increasing their tax liability by substantial amounts. Although deductions which did not reflect economic expenses generally were found to be inappropriate, nonetheless Congress recognized that the difficulties which might result from a sudden increase in the industry's tax burden warranted limited exceptions in this case. Thus, special rules for smaller life insurance companies were provided, since most of these companies enjoyed substantial benefits under prior law. In addition, an across-the-board rate reduction for life insurance companies was adopted which would cushion the impact of the new rules. In addition to these two generally applicable rules, transition rules with limited duration or limited applicability for certain companies (e.g., for mutual companies with much greater than average equities) were adopted because these companies would have experienced a greater increase in tax or greater transitional difficulties than the industry generally with the enactment of the new provisions.

Life insurance products

Policyholders of life insurance products traditionally have enjoyed a special position under the Code. Under prior and present law, policyholders benefit principally from the tax-free accumulation of cash value under life insurance policies. Cash values accumulate under any one of several premium payment systems for whole life insurance which result in larger premium payments in the early years of a contract than required to fund current insurance protection. The buildup occurs when a level premium payment plan applies to the policy, and the premium payments in the early policy years exceed the current cost of insurance computed using assumed mortality table and interest rates. In the later years of the contract, the annual cost of insurance is higher and for the nominal face amount of coverage may exceed the annual level premium payment. The cash value buildup in the policy, however, reduces the actual insurance risk and, therefore, the cost of insurance. Under prior and present law, the policyholder is not taxed on increases in the cash value (for example, from investment earnings) unless the contract is surrendered prior to the death of the insured for an amount in excess of the gross premiums paid. Both cash value and reserves grow as the balances earn interest, but the accruals of interest are not included in the policyholder's gross income and therefore are not subject to taxation. Also, policyholders benefit from the income-tax-free distribution of life insurance proceeds upon the death of the insured and the deductibility of interest payments for indebtedness secured by the tax-free accumulated cash value.

In light of the significant tax advantages associated with life insurance products, the Congress reviewed those products and their tax treatment as part of the 1984 Act. Three areas of concern were identified as appropriate for legislation. First, in recent years, companies have begun emphasizing investment-oriented products that maximize the advantages of the deferral provided in the Code. When compared to traditional life insurance products, these products offer greater initial investments or higher investment returns, or both. In response, the Congress adopted a definition of life insurance that treats as currently taxable investments those life insurance policies that provide for much larger investments or buildups of cash value than traditional products.

Second, with respect to the treatment of annuity contracts, the Congress adopted the view that the present-law deferral of tax on investment income of annuities is justified only by the retirement savings purpose of annuities. Thus, an exception to the early withdrawal penalty for amounts earned on investments that are kept in the annuity contract for at least 10 years was viewed as inappropriate, since it permitted penalty-free pre-retirement withdrawals. Similarly, Congress considered that an unlimited deferral should no longer be allowed when the income in an annuity contract is passed to another generation or to a person other than a spouse. Thus, if the owner dies before annuitization, deferred income should be distributed over a limited period (5 years) unless the annuity passes to a spouse, or is annuitized within one year after such death.

The Congress also recognized that the provision of group term insurance to retired employees is just one of many forms in which deferred compensation can be received and should be taxed as such. Thus, the Congress extended to retired employees the prior and present-law limits on the amount of term life insurance coverage that can be provided to active employees without inclusion of the cost of such insurance in the income of the employee. Likewise, the nondiscrimination rules were also extended.

C. Explanation of Provisions

1. Overview of the Life Insurance Tax Act of 1984

General rules

Title II of the Act contains three subtitles. Subtitle A is the amendment that provides a complete substitute for the prior-law tax treatment of a life insurance company. Prior -law Part I of Subchapter L of the Internal Revenue Code, sections 801-819A, was repealed and replaced by the amendments in subtitle A of title II of the Act. Also, a new section 845, dealing with reinsurance transactions, is added to Part IV of Subchapter L. Subtitle B provides new rules relating to the treatment of life insurance products which are in addition to those of the law in effect prior to the Act. Subtitle C provides for certain studies and reports to the tax committees relating to the tax burden on life insurance.

New Code section 801 imposes an income tax on the taxable income of a life insurance company as defined in section 816. Taxable income is defined as life insurance company gross income less life insurance company deductions. Life insurance company gross income is defined in section 803. The deductions which are allowed to be made from gross income are set forth in section 804, and described in some detail in section 805 (the general deductions) and section 806 (the special deductions). Further specification of these deductions is provided in sections 807 and 817 (rules for reserves and variable contracts), sections 808 and 809 (policyholder dividends), and section 810 (operations loss). Accounting provisions that relate to life insurance company taxation are contained in section 811. In section 812, the company's share and policyholders' share are defined, and the proration of various types of income between the two shares also is described. Sections 813 and 814 relate to foreign life insurance companies and contiguous country branches of domestic life insurance companies.

Subtitle B of title II contains the definition of a life insurance contract (sec. 221), the treatment of annuity contracts (sec. 222), rules relating to group-term life insurance purchased for employees (sec. 223), and a definitional modification with respect to certain exchanges of insurance policies (sec. 224).

Subtitle C contains requirements for studies which will report upon the various aspects of the industry (e.g., revenues, segment balance, etc.). These Treasury studies are to be completed at various dates and reported to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate.

Relationship to the 1959 Act

Although the Act amends the Internal Revenue Code by repealing the life insurance company taxation provisions of the 1959 Act and replacing them with an entirely new Part I of subchapter L, the Congress intended that the provisions of the new Part I which are based on prior law be interpreted in a manner consistent with that law. Thus, where provisions of prior law are incorporated in the Act, the Congress expects that, in the absence of contrary guidance in the committee reports and conference agreement, the regulations, rulings, and case law under prior law will serve as interpretative guides to the new provisions.

2. Tax Treatment of Life Insurance Companies

a. Definition of a life insurance company (sec. 211 of the Act and new sec. 816 of the Code) [6]

Prior Law

A company was taxed as a life insurance company if (1) it was an insurance company; (2) it was engaged in the business of issuing life insurance and annuity contracts (either separately or in combination with accident and health insurance), or noncancellable accident and health insurance contracts; and (3) more than 50 percent of its total reserves were life insurance reserves or unearned premiums and unpaid losses (whether or not ascertained) on noncancellable life, accident or health policies not included in life insurance reserves.

Under prior law, there was no statutory definition of an insurance company. Treasury regulations, however, provide that an insurance company is a company "whose primary and predominant business activity during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies" (Treas. Reg. sec. 1.801-3(a)).

Life insurance reserves are amounts which were (1) computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest, and (2) set aside to mature or liquidate future unaccrued claims arising from life insurance, annuity, and noncancellable health and accident contracts involving (at the time the reserve is computed) life, health or accident contingencies. Also, life insurance reserves must have been required by law. The term total reserves meant (1) life insurance reserves, (2) unearned premiums, and unpaid losses (whether or not ascertained), not included in life insurance reserves, and (3) all other insurance reserves required by law. The term total reserves did not include deficiency reserves.

Explanation of Provision

The Act generally adopts the prior-law test for determining whether an insurance company is a life insurance company and, for this purpose, continues to look to properly computed statutory reserves. However, for purposes of qualifying as a life insurance company, the Act adopts a statutory definition of an insurance company. Specifically, to qualify as an insurance company for purposes of being taxed as a life insurance company, a company must be one for which more than half of the business activity during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies.

By requiring that more than half the business activity rather than that the "primary and predominant business activity" of the company be insurance activity, the Act adopts a stricter and more

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[6] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 211; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1402-1404; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 211; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 525-527; and H. Rep. No. 98-861 (June 23, 1984), pp. 1042-1043 (Conference Report).

precise standard for a company to be taxed as a life insurance company than does the general regulatory definition of an insurance company. Whether more than half of the business activity is related to the issuing of insurance or annuity contracts will depend on the facts and circumstances. Factors to be considered include the relative distribution of the number of employees assigned to, the amount of space allocated to, and the net income derived from, the various business activities. It is the character of the business actually done in the taxable year which determines whether a company is taxable as an insurance company under the Code (see, e.g., *Service Life Insurance Co. v. United States*, 189 F. Supp. 288, *aff'd. on other grounds*, 293 F.2d 78 (8th Cir. 1961)).

Because the definition of a life insurance company under the Act looks to the activities of the company for the entire taxable year, a company will be characterized for that year as a life insurance company, a property and casualty company or an ordinary corporation on the basis of its activities for the entire year. Thus, if more than half a company's business activity during the taxable year is the issuing of insurance and annuity contracts or the reinsuring of risks underwritten by insurance companies, and if more than 50 percent of its total reserves for the taxable year are life insurance reserves or unearned premiums and unpaid losses on noncancellable life, accident or health policies, then the company will be taxable as a life insurance company for such taxable year.[7] Any definitional change from prior law, however, was not intended to override any authority of Treasury to issue regulations under section 1502 relating to the filing of consolidated returns.

The Act adopts the same definition of a life insurance reserve as under prior law. In doing so, the special recognition afforded noncancellable accident and health insurance contracts in the 1959 Act as being comparable to life insurance contracts because of their long-term rate commitments is continued. However, under a special provision (sec. 217(i) of the Act), an insurance company can make a permanent election to treat individual noncancellable (or guaranteed renewable) accident and health contracts as cancellable for purposes of determining the qualification fraction; the election will not otherwise affect the computation of the tax reserves for such contracts. Thus, a company with large amounts of individual noncancellable accident and health business, which might have large surplus requirements, can elect to be taxed as a property and casualty insurance company. An electing company will forfeit the special and small life insurance company deductions. Likewise, any nonelecting life insurance subsidiaries of a mutual life insurance company parent that elects this treatment will be taxed as mutual companies under the life insurance provisions. The assets and the income of the electing parent will be taken into account in determining the amount of the subsidiary's small life insurance company deduction. Congress intended that no new election will be given to these companies if there is a subsequent reform of property and casualty insurance taxation.

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[7] In determining whether a company has the requisite reserve qualifications, the amount of the reserve taken into account for the year is the mean of the reserves at the beginning and the end of the year.

In general, the Act adopts the present-law definition of total reserves. However, the Act also provides that, for purposes of determining whether an insurance company is a life insurance company, amounts set aside and held at interest to satisfy obligations under contracts which do not contain permanent guarantees with respect to life, accident, or health contingencies shall not be included in life insurance reserves or in total reserves. Thus, these amounts are not included in either the numerator or the denominator of the qualification fraction when determining whether a company's life insurance reserves and unearned premiums and unpaid losses on noncancellable accident and health insurance contracts comprise more than half its total reserves.[8] This provision resolves for future years a question under prior law as to how certain pension funds that do not contain permanent annuity purchase rate guarantees should be treated.[9]

The Internal Revenue Service has ruled that a reserve for a benefit is not a life insurance reserve unless a life benefit is permanently guaranteed under the contract (Rev. Rul. 77-286, 1977-2 C.B. 228). The Act substantially adopts this position and extends it to total reserves also, but only for purposes of the qualification fraction. The fact that such funds are not treated as insurance reserves for purposes of the qualification fraction was not intended to have any other effect on the characterization of the contracts or of the company issuing the contracts. Rather, whether a contract with less than a permanent guarantee should be considered an insurance or annuity contract depends on the terms of the contract. That is, it depends on whether the company has assumed a significant insurance risk or has made an annuity guarantee (for life or a fixed period). Generally, the assumption of solely an investment risk would not give rise to an insurance liability.

Because of a general change in State law, as well as new rules for computing tax reserves, the prior-law provision that excluded deficiency reserves from the definition of life insurance reserves and total reserves was eliminated.[10] Rather, the new rules for computing tax reserves prohibit a company from taking into account any State requirements for "deficiency reserves" caused by a premium undercharge for purposes of computing the company's increase in reserve deduction.

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[8] If these contracts have any insurance or annuity purchase rate guarantees (for life or a fixed term), then the premiums will be taken into income and the increase in the fund will be treated as increases in a reserve item under section 807(c)(3) or (4). If there are no guarantees whatsoever, then no income will be taken into account and no reserves will be treated as increased for purposes of the reserve deduction.

[9] The question was temporarily mooted by a TEFRA provision which prevented any company from changing its life insurance company status because of the treatment of such reserve funds.

[10] See the discussion of new section 813 for the effect of this change on the determination of the Secretary's ratio for foreign life insurance companies doing business in the United States.

b. Computation of life insurance company taxable income (sec. 211 of the Act and new secs. 801, 803, 804, 805, and 806 of the Code) [11]

Prior Law

A life insurance company was subject to a three-phase taxable income computation under Federal tax law. Under the three-phase system a company was taxed on the lesser of its gain from operations or its taxable investment income (Phase I) and, if its gain from operations exceeded its taxable investment income, 50 percent of such excess (Phase II). Federal income tax on the other 50 percent of the gain from operations was accounted for as part of a policyholders' surplus account and, subject to certain limitations, taxed only when distributed to stockholders or upon corporate dissolution (Phase III). Thus, although life insurance companies were taxed at the normal corporate rates under prior law, special accounting rules were provided for computing taxable income. Consistent with the taxation of other taxpayers, net capital gain that is taxable to the company may be subject to an alternative tax.

Explanation of Provisions

Life insurance company taxable income (new sec. 801)

Under the Act, a life insurance company is taxed at corporate rates, under a single-phase system, on its life insurance company taxable income (LICTI). LICTI is life insurance gross income reduced by life insurance deductions. As under prior law, net capital gain that is taxable to the company may be subject to an alternative tax. A stock life insurance company will be taxed, at corporate rates, on any distributions from a pre-1984 policyholders' surplus account.

In general, as described below, a special life insurance company deduction and a small life insurance company deduction each result, in effect, in a lowering of the tax rates on LICTI. However, if amounts are subject to the alternative tax on capital gains, the special life insurance company and small life insurance company deductions do not reduce the amounts subject to that tax, because the Act already provides a lower than normal tax rate (new sec. 801) through application of the alternative tax.

Life insurance gross income (new sec. 803)

Under the Act, life insurance gross income is the sum of (1) premiums, (2) decreases in certain reserves, and (3) other amounts generally includible by a taxpayer in gross income. For these purposes, premiums consist of the gross amount of premiums and other consideration received on insurance and annuity contracts reduced by return premiums paid to policyholders, such as on the cancellation

[11] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 211; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1404-1410; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 211; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 527-536; and H. Rep. No. 98-861 (June 23, 1984), pp. 1043-1049 (Conference Report).

of a policy, and premiums and other consideration paid to another insurer on indemnity reinsurance (new sec. 803).

As under prior law, the premiums and other consideration taken into account include advance premiums, deposits, fees, assessments, consideration in respect of assuming liabilities under contracts not issued by the taxpayer, and any policyholder dividends reimbursable by a reinsurer. Return premiums do not include amounts paid to policyholders that are not fixed in the contract but depend on the experience of the company or the discretion of the management, except in the case of return premiums or other consideration returned to another life insurance company under an indemnity reinsurance contract. Amounts rebated or returned due to policy cancellations or to erroneously computed premiums are to be treated as return premiums.

The use of the term "indemnity reinsurance" in the Act, instead of "reinsurance ceded" under prior law, is not intended to be a substantive change from prior law. Likewise, the reference to "insurance and annuity contract" rather than to "insurance and annuity contracts (including contracts supplementary thereto)" is not a substantive change from prior law. A general provision, applicable to the life insurance company part of the Code only, states that any reference to insurance and annuity contracts includes any contract supplementary thereto (new sec. 818(d)).

Life insurance deductions (new sec. 804)

In general, under the Act, life insurance deductions consist of "general" life insurance deductions (new sec. 805), the "special life insurance company deduction" (new sec. 806(a)), and the "small life insurance company deduction" (new sec. 806(b)).

The general deductions (new sec. 805)

The general deductions are largely the same as the deductions allowed under prior law, except that the deductions that were available to life insurance companies for nonparticipating and group life contracts and accident and health contracts are eliminated. The general deductions, under the Act, are the deductions for (1) claims and benefits accrued, and losses incurred (whether or not ascertained) during the taxable year on insurance and annuity contracts, (2) net increases in reserves (see item d. below), (3) policyholder dividends (see item e. below), (4) dividends received by the company (limited to the company's share), (5) operations losses (see item f. below), (6) consideration paid for assumption reinsurance, and (7) policyholder dividend reimbursements paid to another insurance company under a reinsurance agreement. In addition, life insurance companies are allowed other deductions generally allowable to corporate taxpayers for purposes of computing taxable income, subject to certain modifications. These modifications are generally the same as under prior law.

Intercorporate dividends.—With respect to the deduction for intercorporate dividends received by a life insurance company, in general the Act continues the prior-law rule of prorating the deduction between the company and the policyholders as the items of investment income are allocated between the company and the policyholders. (See the discussion of new section 812 in item h. below.)

However, "100 percent dividends" (i.e., dividends that would be 100 percent deductible under sections 243 or 244, and certain dividends received by foreign corporations that would be 100 percent dividends but for the domicile of the recipient) generally are not subject to proration. Such dividends are subject to proration to the extent they are funded with tax-exempt interest or with dividends that would not qualify as 100 percent dividends in the hands of the taxpayer. For purposes of applying the exception, multi-tiered corporate ownership arrangements cannot be used to change the character of the tax-exempt interest and dividends received in an attempt to avoid proper proration.

For purposes of determining how much of a 100 percent dividend has been funded with of tax-exempt interest or dividends other than 100 percent dividends, a distribution is considered to be funded ratably out of tax-exempt interest, dividends that would not qualify as 100 percent dividends to the taxpayer, and all other items that contribute to earnings and profits of the distributing company. As with any dividend distribution, for these purposes, the dividend is considered to be made out of earnings and profits for the taxable year and out of accumulated earnings and profits; every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits (sec. 316 of the Code). A comparison should be made between the amount that previously undistributed tax-exempt interest and dividends other than 100 percent dividends have contributed to a company's current or post-1983 accumulated earnings and profits and all such current or accumulated earnings and profits immediately prior to the distribution.

For example, assume that a subsidiary company *S* of life insurance company *L* had accumulated earnings and profits of $300x at the end of 1983. During 1984, *S* had current earnings and profits of $100x, $40x of which was attributable to its benefit from tax-exempt interest; during 1985, *S* has current earnings and profits of $150x, $50x of which is attributable to tax-exempt interest. At the end of 1985, *S* declares and pays dividends to *L* of $200x. Under the provision described above, $70x of the 100 percent dividend distribution should be considered to be out of tax-exempt interest: $50x out of the $150x distributed from current earnings and profits (50/150 times $150x) and $20x out of the $50x distributed from 1984 accumulated earnings and profits (40/100 times $50x). Suppose, during 1986, *S* had earnings and profits of $200x, $75x of which was attributable to its benefit from tax-exempt interest and, at the end of 1986, *S* pays dividends to *L* of $300x. Under the provision, $95x of the 100 percent dividend distribution should be considered to be out of tax-exempt interest: $75x out of the $200x distributed from current earnings and profits (75/200 times $200x); none from the 1985 accumulated earnings and profits (which were entirely distributed the previous year); $20x out of the $50x distributed from the remaining 1984 accumulated earnings and profits (20/50 times $50x); and none from pre-1984 accumulated earnings and profits (0/300 times $50x). This interpretation of the dividends-received proration provision is consistent with the definition of a dividend as a distribution out of earnings and profits (and not out of other amounts). Any other interpretation either would require the establishment of a unique set of earnings and profits accounting provisions, or would result potentially in year-to-year distortions because of annual variations in the proration formula.

The rationale for this special rule is that dividends received by a life insurance company parent from a subsidiary represent the earnings of the subsidiary. To the extent they are distributions of fully taxable income, these earnings have already been taxed at the subsidiary level. Including them in gross investment income would have, through operation of the proration formula, the implicit effect of taxing a portion of these earnings a second time, although the earnings remain within the same related group. However, to the extent these earnings are distributions of tax-exempt income (tax-exempt interest and dividends other than 100 percent dividends), they have not been taxed within the related group and should be subject to proration. Without this rule, a parent life insurance company could avoid proration of tax-exempt interest by having a subsidiary own all of its tax-exempt obligations. The subsidiary would not be taxed on this income, which it could distribute to the parent as dividends. However, the rule avoids this result by including in gross investment income (without a completely offsetting dividends-received deduction) dividends received from a subsidiary to the extent that such dividends are distributions of tax-exempt interest or of dividend income that would not be 100 percent deductible if received directly by the taxpayer.

The Congress was aware that, as under prior law, the proration of tax-exempt income can also be avoided by distributing surplus in the form of dividends to a parent (nonlife insurance) company that could invest in tax-exempt income. This possibility was less troublesome than that of placing assets in a subsidiary because assets of a parent do not contribute to a company's surplus while assets of a subsidiary do. This difference effectively places a limitation on the amount of assets which a company may pay as dividends to a parent without jeopardizing its ability to do business under State law.

Reimbursable policyholder dividends.—The specific deduction for policyholder dividend reimbursements paid by a life insurance company to another insurance company under a reinsurance agreement was originally adopted under TEFRA, as was the rule that all policyholder dividends paid by an insurance company directly insuring the policyholder are to be treated as paid by that company. The Act adopted both provisions.[12] The Act clarifies, however, that these reimbursements for policyholder dividends are expenses of the reinsuring company (the reinsurer) and are not policyholder dividends as defined for tax purposes. Also, the Act specifically uses the term "reimbursable dividends" both in referring to the deduction allowed therefor, and in referring to the inclusion of such dividends in income by the direct writer of the insurance, in order

[12] The Congress also adopted an amendment (sec. 217(g) of the Act) to the TEFRA provisions for taxable years 1981 and 1982 which is an exception to the reimbursable dividends rule. Reimbursable dividends paid pursuant to a reinsurance agreement entered into before June 30, 1955, by a life insurance company to reinsure their accident and health policies, pursuant to the direction of the National Association of Insurance Commissioners, will be treated as policyholder dividends of the reinsurer.

to clarify that such dividends are deductible and includible in income on an accrual accounting basis.

The special life insurance company deduction (new sec. 806(a))

A life insurance company is allowed a deduction for any taxable year of 20 percent of its "tentative life insurance company taxable income" (tentative LICTI) over the amount of the company's small life insurance company deduction. The Congress believed that although the Act provides for the proper reflection of the economic income of a life insurance company without this deduction, some adjustment was necessary to avoid suddenly imposing a substantially increased tax burden on life insurance companies. Under prior law, a life insurance company was able to defer or avoid taxation on a substantial portion of its current income, and thus this provision ameliorates the hardship that might otherwise result from a sudden, substantial increase in a company's tax base.

As indicated above, the tax base for the special life insurance company deduction is tentative LICTI. Generally, a company's tentative LICTI is its life insurance company taxable income determined without regard to (1) the special life insurance company and small life insurance company deductions, and (2) any items (income or loss) attributable to any noninsurance business.

Under this provision, the special life insurance company deduction applies only with respect to income resulting from a company's life insurance business. Thus, gains and losses arising from a noninsurance business operated by a life insurance company will neither increase nor decrease the amount of the company's special life insurance company deduction (or small life insurance company deduction). For these purposes, noninsurance business means any activity which is not an insurance business. Generally, insurance business refers to the business activity of issuing insurance and annuity contracts and the reinsuring of risks underwritten by insurance companies. Also, certain investment activities and administrative services are treated as insurance business under a statutory modification of the concepts of insurance and noninsurance business. That is, any activity that is not an insurance business but is of a type traditionally carried on by life insurance companies for investment purposes is treated as insurance business if the activities do not constitute the the active conduct of a trade or business. Thus, the insurance/noninsurance business distinction includes a distinction between passive and active investment activities under which all passive investment income is treated as insurance business and, generally, investment income from active business operations is treated as noninsurance business. Real estate activities will be treated as insurance business if they are of a type traditionally carried on by life insurance companies and are carried on for investment purposes, whether or not they constitute the active conduct of a trade of business. Also, the performance of administrative services in connection with any plans providing life insurance, pension, or accident and health benefits is treated as insurance business. These modifications recognize that life insurance companies have traditionally engaged in certain types of investment or income-producing activities that could be viewed as noninsurance activities.

Whether an activity will be treated as insurance business or noninsurance business depends on the nature of the activity itself, regardless of whether the assets and income related to the activity are financially supportive of the insurance business operation. Thus, for example, if a life insurance company runs a manufacturing business directly (rather than owning stock in the company), any income and deduction items attributable to the manufacturing business will not be taken into account in computing tentative LICTI. Likewise, if a life insurance company acts as a broker, buying and selling securities directly for the public, such activities will be noninsurance business. Also, for example, even though a company might choose to invest premium receipts in an oil or gas joint venture and use the investment return therefrom to meet policy obligations, gain or loss arising from the joint venture will be treated as a noninsurance gain or loss if the company's participation in the joint venture constitutes the conduct of a trade or business.[13] On the other hand, participation in an oil and gas venture solely as a limited partner will ordinarily be treated as a passive investment activity, income and expenses of which will be treated as part of the insurance business. By the same token, the ownership of stock will always be treated as insurance business because it is essentially a passive investment activity, even when the stock ownership results in the life insurance company having control of another company.

The general insurance/noninsurance distinction that is made for purposes of computing the amount of the special deduction is intended to prevent a company from obtaining a tax rate on income from noninsurance activities that is lower (through the operation of the special deduction) than would be applied if the activities were carried on in a separate nonlife insurance company.[14] At the same time, the Congress recognized that a life insurance company should not be allowed a greater advantage by carrying on, within the company, noninsurance activities that result in losses than would result if those same activities were carried on in a separate company. Thus, the Act adopts the provision that a loss from noninsurance activities will be treated as a gain or loss of a noninsurance subsidiary of the life insurance company that joined in the filing of a consolidated return with that life insurance company. This results in the application of the general principles of life-nonlife consolidation (sec. 1503(c)) for purposes of combining income and losses from insurance and noninsurance business activities in computing the LICTI of a life insurance company.

For example, noninsurance losses taken into account for purposes of computing LICTI (after the special deduction and small life

[13] Under a special rule (sec. 217(m)), one company is permitted to treat the ownership of any undivided interest in an oil or gas operating mineral interest held on December 31, 1983, as part of its insurance business. This company was incorporated in March 1857 and had cost for the interests in excess of $250,000,000.

[14] This characterization of an activity as insurance or noninsurance business, based on whether it is a passive investment or an active trade or business, is to apply only with respect to the determination of the amount of the special life insurance company deduction and small life insurance company deduction and the computation of LICTI, and is not intended to be used for purposes of determining whether a company is a life insurance company for tax purposes. Qualification as a life insurance company will be determined under rules similar to those of prior law.

insurance company deduction) for a taxable year will be limited to 35 percent of the lesser of the noninsurance loss or LICTI (without regard to the noninsurance loss). It is anticipated that regulations under section 1503(c) will develop rules for the treatment of such noninsurance income or losses within a life-nonlife consolidated group that are consistent with the treatment of such items for purposes of computing LICTI of a single life insurance company.

In general, the Act limits the amount of the special life insurance company deduction by treating all life insurance companies that are members of the same controlled group as one company whether such companies join in the filing of a consolidated return or file separate returns. The special life insurance company deduction is then allocated proportionally among those life insurance company members of such group having a positive tentative LICTI. For these purposes, the term controlled group is defined generally by reference to section 1563. In prescribing this rule, it was recognized that the gain or loss of any life insurance company member will be reflected in the computation of the affiliated group's tentative life insurance company income, even if that particular member is not allowed to join in the consolidated return because it has not been a member of the affiliated group for the required time or is a foreign corporation. To eliminate any excessive detriment or benefit (from year to year) arising from the operation of the controlled group tentative LICTI computation, the Act provides special regulatory authority for the Secretary of the Treasury to prescribe proper adjustments to be made in the application of this provision.

In lieu of this rule, the Act also permits a life insurance company with a loss from operations to elect, with respect to the taxable year, to have its loss not taken into account by other life insurance companies that are within the same controlled group as the loss company but that do not file a consolidated return with the loss company in the year of the election. If this election is made, a limitation is imposed on the ability to utilize losses of the electing loss company against nonlife company income. Only 80 percent of the life company losses that, but for the election, would have reduced the controlled group's tentative LICTI can be used to offset nonlife income. Life company losses subject to the 80 percent limitation are considered to be used in full when applied against nonlife company income; that is, there is no carryover of the remaining 20 percent of life company loss. Under an ordering rule, life company losses subject to the 80 percent limitation are applied in consolidation against nonlife company income before the use of any life company losses not subject to the limitation. This election is not applicable with respect to the computation of the small life insurance company deduction.

Life company losses that are not applied against nonlife company income in the year of the election may be carried over. Such losses must first be applied against life company income in a carryover year and, to the extent so applied, are not subject to the 80 percent limitation. Life company losses carried over and used against nonlife company income are subject to the 80 percent limitation to the extent of other life company income of the controlled group not taken into account in computing the 80 percent limitation in that or any prior year.

For instance, suppose that foreign life company *P* conducts U.S. insurance operations through branch *B* and U.S. life subsidiary *L*. All of *L*'s stock is held by *P*'s U.S. noninsurance subsidiary *N*. *B* has income of $50, *N* has income of $70, and *L* has a loss of $100. If *L* makes the election described above, then *B*'s special deduction would be .20 x $50=$10. In computing the consolidated income of the *N* affiliated group, $50 of *L*'s losses—i.e., *L*'s losses to the extent of *B*'s income—would be subject to the 80 percent limitation. Thus, under the ordering rule, *N*'s $70 of income would be offset by $40 of limitation losses ($50 x .80) and $30 of nonlimitation losses. *L* would have a loss carryover of $20. Assume that the loss cannot be carried back to prior years. If, in the subsequent year, *L* and *N* each has income of $10 and *B* has income of $5 and an election was made, the carryforward of $20 would first be applied without limitation to the $10 of *L*'s income. $5 of the remaining $10 carryforward would, due to *B*'s income, be subject to the 80 percent limitation when offset in consolidation against *N*'s income. The remaining $5 carryforward could be used without limitation against *N*'s income. The affiliated group would thus have taxable income in the subsequent year of $1 ($20 -$10 -(.8)($5) -$5).

Also, a special rule applies to corporations joining in the filing of a consolidated Federal income tax return. Under this rule, no items of income or loss of nonlife members of the affiliated group joining in the return are taken into account for purposes of computing tentative LICTI.

The small life insurance company deduction (new sec. 806(b))

Under the Act, small life insurance companies are allowed an additional special deduction that is not available to other taxpayers. This deduction also is based on tentative LICTI, and applies before the special life insurance company deduction.

The amount of the deduction is 60 percent of so much of tentative LICTI for such taxable year as does not exceed $3,000,000, reduced by 15 percent of the excess of tentative LICTI over $3,000,000. For example, if a small life insurance company has tentative LICTI of $2,900,000, its small life insurance company deduction would be $1,740,000 (i.e., 60 percent of $2,900,000). If the company's tentative LICTI is $3,900,000, its small life insurance company deduction would be $1,665,000 (i.e., 60 percent of $3,000,000 reduced by 15 percent of the excess of $3,900,000 over $3,000,000). Under this provision, the maximum deduction that can be claimed by a small company is $1.8 million, and a company with a tentative LICTI of $15 million or more would not be entitled to any small company deduction. For these purposes, the term tentative LICTI has the same meaning as it does for purposes of the special life insurance company deduction, that is, it does not include any items (income or loss) attributable to a noninsurance business.

As in the case of the special life insurance company deduction, the small life insurance company deduction is computed by treating all life insurance companies that are members of the same controlled group as one company whether those companies join in the filing of a consolidated return or file separate returns. The small life insurance company deduction is then allocated proportionately among the life insurance company members of such group having positive tentative LICTI.

The small life insurance company deduction is only allowable to companies with gross assets of less than $500,000,000. Except for real property and stock, which are valued at fair market value, an asset is treated as having a value equal to its adjusted Federal income tax basis for purposes of determining gain. Interests in partnerships or trusts are not treated as assets of the company. Rather, a company is treated as owning its proportionate share of the assets of any partnership or trust in which it has an interest. These rules are intended to prevent companies from holding assets in a noncorporate entity in order to qualify for the small company deduction. With some modifications, this approach for valuing assets is consistent with the valuation of assets of life insurance companies for tax purposes under prior law.

The asset qualification for the small company deduction is determined on the basis of a controlled group as defined in section 1563. In general, the Congress believed that this controlled group rule, which takes into account both insurance and noninsurance businesses, was appropriate because the small companies that require additional preferential treatment are those that cannot look to a parent corporation or an affiliate with substantial assets for capital during their growth period. Similarly, the restriction prevents the small company deduction from creating an incentive for large noninsurance businesses to take over small independent insurers.[15]

As in the case of the special life insurance company deduction, the Congress believed that, without this provision, the Act provided for the proper reflection of taxable income. Nonetheless, the Congress recognized that small life insurance companies have enjoyed a tax-favored status for some time, and believed that it would not be appropriate to dramatically increase their tax burden at this time.

c. Policyholders surplus accounts (sec. 211 of the Act and new sec. 815 of the Code) [16]

Prior Law

As noted above, prior law permitted stock life insurance companies to defer the tax on 50 percent of their gain from operations in

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[15] However, a one-year transition period for purposes of applying the asset aggregation rule was recognized for cases in which transactions between noninsurance members (that do not act in the capacity of financial intermediaries) and the insurance members of a controlled group indicate that the capital of the noninsurance members is not available to the insurance members (sec. 217(h) of the Act). Specifically, for 1984, the gross asset requirement for the small company deduction will be determined by aggregating only the assets of controlled group members that can be classified as financial intermediaries (e.g., insurance companies, banks, savings and loans, finance companies, securities brokers, and similar institutions), provided the following requirements are also met: (1) a life insurance company was not added to the controlled group after September 27, 1983; (2) an election for life-nonlife consolidation is not in effect; and (3) the capital received by life company members of the controlled group from nonlife company members after January 1, 1983, does not exceed dividends paid by the life company members after such date. See section 217(h) of the Act.

[16] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 211; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1410-1411; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 211; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 536-537; and H. Rep. No. 98-861 (June 23, 1984), pp. 1049-1050 (Conference Report).

excess of their taxable investment income. The deferred income was added to a policyholders surplus account, along with amounts deducted for nonparticipating contracts and group life and accident and health insurance contracts. Amounts in the policyholders surplus account were taxed only when distributed by the company to its shareholders. To determine whether amounts have been distributed, a company must maintain a shareholders surplus account which generally includes the company's previously taxed income and certain nontaxable items that would be available for distribution to shareholders. Distributions to shareholders are treated as being first out of the shareholders surplus account, then out of the policyholders surplus account and finally out of other accounts.

Explanation of Provision

In general, the Act eliminates any further deferral of tax with regard to income for 1984 and later years. Although companies will not be able to enlarge their policyholders surplus account after 1983, they will not be taxed on previously deferred amounts unless they are treated as distributed to shareholders or subtracted from the policyholders surplus account under rules that are comparable to those provided under the 1959 Act, but that reflect the basic changes in the tax structure under the Act. The Act provides that any direct or indirect distribution to shareholders from an existing policyholders surplus account of a stock life insurance company will be subject to tax at the corporate rate in the taxable year of the distribution.

For these purposes, the term distribution is intended to include actual and constructive distributions. See *Union Bankers Insurance Co. v. Commissioner*, 64 T.C. 807 (1975). The citation to *Union Bankers Insurance Co.* indicates the type of fact situations in which liability for a phase III tax could arise. The statutory emphasis on taxing both direct and indirect distributions from the policyholders surplus account was intended to be construed broadly, whether or not there is a distribution specifically within the meaning of section 301 or 302. There would be a direct distribution from the policyholders surplus account whenever there is a distribution to shareholders within the meaning of section 301 or 302. There would be an indirect distribution therefrom whenever policyholders surplus account funds are used to benefit the shareholders indirectly (for example, by having the stock life insurance company purchase the parent's stock either from the parent or a shareholder of the parent, or by having the company make loans to the parent whether or not for adequate consideration).

When there are distributions from the policyholders surplus account, the amount of the distribution (whether actual or deemed, or by the indirect use of amounts in the policyholders surplus account for the benefit of shareholders) is taxed in addition to LICTI and not as part of the LICTI computation. Thus, distributions from the policyholders surplus account cannot be offset by life insurance company losses and are not subject to the special and small life insurance company deductions.

Although new amounts will not be added to the policyholders surplus account, a shareholders surplus account must be continued in order to maintain a record for tax purposes of amounts eligible for distribution before a distribution is made from the policyholders surplus account. The shareholders surplus account continues to be maintained as an account of certain positive additions representing items that can be characterized generally as previously taxed or nontaxable amounts that would be available for distribution to shareholders before requiring a distribution from the policyholders' surplus account. However, the Act provides for appropriate additions to the shareholders surplus account based on the new provisions adopted and replacing the 1959 Act.

Specifically, for each taxable year, the excess of the sum of the following amounts over the taxes paid for the year will be added to the shareholders surplus account: (1) LICTI (but not below zero); (2) the special life insurance company deduction; (3) the small life insurance company deduction; (4) the deduction allowed the company for intercorporate dividends received; and (5) excluded tax-exempt interest. In developing this list of additions to the shareholders surplus account under the new provisions, additions for certain capital gains and the policyholders' share of the intercorporate dividend deduction were not included in order to prevent some of the double counting that existed under the 1959 Act. Also, the addition for the small company deduction of $25,000 under the 1959 Act was eliminated as was that deduction under the new tax structure. On the other hand, under the Act, the amount of the new special life insurance company deduction of 20 percent of tentative LICTI is added to the shareholders' surplus account, along with the new small life insurance company deduction. These new items may substantially increase annual additions to the shareholder surplus account, in comparison with present law, and thus may more than offset modifications made to the account to eliminate double counting.

Aside from the changes indicated for maintaining the shareholders surplus account, the Act generally adopts the provisions of the 1959 Act with respect to the phase III tax.[17] Thus, the ordering rules for distributions and subtractions, the requirement that distributions from the policyholders surplus account be "grossed up" for taxes payable thereon, and limitations on the size of the policyholders surplus account as a percentage of reserves, in general, will continue to apply. In so continuing these provisions, the Congress intended that any reference to reserves be to reserves computed in a manner consistent with the provisions of the 1959 Act.

[17] The reenactment of prior-law sec. 819 with conforming modifications as new sec. 813 did not include the special rule under prior law for allocating dividends by a foreign life insurance company for purposes of determining when there is a distribution from the policyholders surplus account. This rule was intended to be incorporated as part of new sec. 815 under the policy adopted that amounts in the policyholders surplus account will be taxed under rules comparable to those under the 1959 Act.

d. Deductions with respect to reserves (sec. 211 of the Act and new secs. 807 and 817 of the Code) [18]

Prior Law

A life insurance company is allowed to deduct (or exclude from income) increases in its year-end reserves over those for the prior year. Under prior law, there were two elements to the deduction for reserves. First, for purposes of computing its taxable investment income, a life insurance company could exclude from its investment yield (i.e., gross investment income less investment and similar expenses) the policyholders' share of that investment yield. Second, for purposes of computing gain and loss from operations, a life insurance company could deduct increases in reserves allocable to premium income (i.e., increases in reserves, adjusted to not include required interest that is credited to its reserves and excluded in the computation of taxable investment income). A life insurance company's tax reserves were based on its reserves for State regulatory purposes (i.e., statutory reserves) and, as a general rule, a company's deduction reflected an increase in its statutory reserves over its statutory reserves for the prior year.

Under prior law, life insurance reserves must have been (1) required under State law, (2) computed or estimated on the basis of recognized mortality or morbidity tables and an assumed rate of interest, and (3) set aside to mature or liquidate future unaccrued claims under life, annuity, or noncancellable accident and health insurance contracts.

Statutory reserves are calculated under a preliminary term method or the net level premium method. Generally, under a preliminary term method, first year expenses (e.g., commissions) are treated as funded out of the premiums for the first year, and only the excess of premiums reduced by such expenses is available to fund reserves. Under the net level method, the first year expenses are treated as funded out of premiums over the life of the contract. Companies using this method for State regulatory purposes have larger reserves in the early years of a contract than companies using the preliminary term method. However, because expenses not funded out of premiums must be funded out of surplus, the net level method is, for all practical purposes, not generally available to companies with limited amounts of surplus.

A life insurance company was allowed to revalue its preliminary term reserves for tax purposes to eliminate a disparity in tax treatment that otherwise would have resulted between life insurance companies with greater amounts of surplus and companies with smaller surplus accounts. Reserves computed for statutory purposes on a preliminary term basis could be revalued to a net level premium basis using either an exact revaluation or an approximate revaluation. Reserves revalued under the approximate formula (as modified by TEFRA) were revalued by increasing such re-

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[18] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 211; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1411-1420; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 211; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 537-546; and H. Rep. No. 98-861 (June 23, 1984), pp. 1050-1056 (Conference Report).

serves by (1) $19 per $1,000 of insurance in force for other than term insurance, less 1.9 percent of the reserves under such contracts, and by (2) $5 per $1,000 of term insurance in force under such contracts which at the time of issuance cover a period of more than 15 years, less 0.5 percent of the reserves under such contracts. The approximate revaluation formula could result in greater reserves than actual net level premium reserves or reserves recomputed using exact revaluation.

Under prior and present law, if as of the close of any taxable year the basis for determining the amount of any increase or decrease in reserves differs from the basis for such determination as of the close of the preceding taxable year, any resulting income or loss is taken into account ratably over a 10-year period.

In addition to the rules described above which apply to life insurance contracts, other rules provide for unearned premium and unpaid loss reserves for accident and health insurance contracts. Under these rules, unpaid losses may be estimated and reserved for on a nondiscounted basis. For purposes of determining the amount of the deduction for the addition to the unearned premium reserve, gross premiums are considered to be earned pro rata over the life of the contract.

Explanation of Provisions

In general, life insurance companies are allowed a deduction for a net increase in reserves and must take into income any net decrease in reserves. Unlike their treatment under the 1959 Act, the deduction for increases in reserves takes into account increases due to both premiums and assumed interest credited to the reserves. In general, the net increase or net decrease in reserves is computed by comparing the closing balance for reserves to the opening balance of the reserves, with the closing balance of the reserve becoming the opening balance for the following year.

Also, in computing the net increase or net decrease in reserves, the closing balance of the reserve items is reduced by the policyholders' share of tax-exempt interest. This continues the view under prior law that a life insurance company's reserve liability to its policyholders in effect entitles the policyholders to a pro rata portion of each item of investment income.

Reserves taken into account

In computing the net increase or net decrease in reserves, the Act specifies that six items, which are all reserves or in the nature of reserves, be taken into account. These are (1) life insurance reserves; (2) unearned premiums and unpaid losses included in total reserves; (3) amounts that are discounted at interest to satisfy obligations which are obligations under insurance and annuity contracts which do not involve life, accident, or health contingencies when the computation is made; (4) dividend accumulations and other amounts held at interest in connection with insurance and annuity contracts;[19] (5) premiums received in advance and liabil-

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[19] The investment portion of any life insurance contract which fails to meet the definition of a life insurance contract under section 7702 is treated as a reserve under section 807(c)(4).

ities for premium deposit funds; and (6) reasonable special contingency reserves under contracts of group term life insurance or group accident and health insurance which are held for retired lives, premium stabilization, or a combination of both.

The six items specified in the Act generally are the same items as under prior law. However, the Act requires that the amount of the contingency reserves held for retired lives and premium stabilization be reasonable in relation to the amount of coverage provided by, and the loss experience suffered by, the company with respect to the underlying group contract. See also changes made by the Act in the employee benefit area (new sec. 419A). Also, the Act requires that the discount rate used by the companies for a reserve amount for an insurance and annuity obligation that does not involve life, accident, or health contingencies be the higher of the prevailing State assumed interest rate or the interest rate assumed by the company in determining the guaranteed benefits. These rates are to be determined when the obligation first ceases to involve life, accident, or health contingencies.

The statutory listing of items to be taken into account in computing the net increase or net decrease in reserves refers to life insurance reserves "as defined in section 816(a)." Section 816(a) requires a proper computation of reserves under State law for purposes of qualifying as a life insurance company. This cross reference is intended merely to identify the type of reserve for which increases and decreases should be taken into account and is not intended to superimpose the requirement of proper computation of State law reserves for purposes of allowing increases in such reserves to be recognized. Conceivably, a similar reference in prior law required proper computation under State law in order for deductions to be allowed, because prior law used the statutory reserves as the basis for measuring deductions and income for tax purposes. The Act, however, takes a new approach by prescribing specific rules for computing life insurance reserves for tax purposes, and as a consequence, the amount of the deduction allowable or income includible in any tax year is prescribed regardless of the method employed in computing State statutory reserves. Thus, a company cannot improperly compute a reserve for a liability involving a life contingency to avoid the Federally prescribed reserve computation, and for example claim treatment as unearned premiums, in order to use statutory reserve amounts for tax purposes.

Computation of reserves

For purposes of determining life insurance company taxable income, the Act provides that the life insurance reserves for any contract shall be the greater of the net surrender value of the contract or the reserves determined under Federally prescribed rules. In no event will the amount of the tax reserves at any time exceed the amount of the statutory reserves, which (given the general definition thereof in new sec. 809(b)(4)(B)(i)) include also any deficiency reserves relating to the liabilities. The net surrender value is the cash surrender value reduced by any surrender penalty except that any market value adjustment required on surrender is not taken into account.[20]

Generally, the comparison of the net surrender value of a contract and the Federally prescribed reserves for the benefits under the contract is made on an aggregate benefit basis; however, the comparison may be made on a benefit-by-benefit basis if the benefit is a qualified supplemental benefit or a qualified substandard risk (see discussion below on special rules). Also, the comparison of contract cash surrender values and Federally prescribed reserves can be made on a group summary basis (i.e., grouping contracts that are identical as to plan of insurance, year of issue or contract duration, age of issue, etc.) or on an individual contract (or seriatum) basis. The Act requires the comparison of tax reserves with statutory reserves as well as the comparison of the Federally prescribed reserve with the net surrender value. The net surrender value represents the current contractual cash benefit payable under a policy, while the reserves reflect all the benefits (including the net surrender value) payable under a policy. Thus, in making the comparisons prescribed in the statute, consistent assumptions must be made with respect to whether a group summary or individual basis is used, whether mean reserves are used, and what premium paid to date is used.

The Act requires that, in computing the Federally prescribed reserve for any type of contract, the tax reserve method applicable to that contract must be used, along with the prevailing State assumed interest rate and the prevailing commissioners' standard tables for mortality or morbidity. Thus, in computing the Federally prescribed reserve, a company should begin with its statutory or annual statement reserve, and modify that reserve to take into account the prescribed method, the prevailing interest rate, the prevailing mortality or morbidity table, as well as the elimination of any net deferred and uncollected premiums (see new sec. 811(c)) and the elimination of any reserve in respect of "excess interest" guaranteed beyond the end of the taxable year (see new sec. 811(d)). Except for the Federally prescribed items, the methods and assumptions employed in computing the Federally prescribed reserve (e.g., whether to use a continuous or curtate function) should be consistent with those employed in computing a company's statutory reserve. The prescribed rules for computing tax reserves are intended, generally, to allow companies to recognize at least the minimum reserve that most States would require them to set aside, but no more unless the net surrender value is greater. However, to avoid State-by-State variations, the rules prescribed in the Act are based on the general guidelines recommended by the National Association of Insurance Commissioners (NAIC) and adopted by a majority of the States.

Reserve method

With respect to the reserve method to be used, the Act prescribes specific tax reserve methods for particular types of contracts. For life insurance contracts, the prescribed method is the applicable

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[20] As under new sec. 7702(f)(2), net surrender value is determined with regard to surrender charges, but without regard to any policy loan.

Commissioners' Reserve Valuation Method (CRVM) in effect when the contract is issued. Generally, this is the date that appears on the policy form. For annuity contracts, the prescribed method is the applicable Commissioners' Annuities Reserve Valuation Method in effect when the contract is issued. For noncancellable accident and health insurance contracts, a 2-year full preliminary term method is required.[21] Finally, for all other contracts, the reserve method prescribed by the NAIC or, if no method is so prescribed, a method consistent with whichever of the prescribed methods that would be most appropriate for the contract must be used. An example of a life insurance contract not covered until recently by an NAIC prescribed method was a universal life insurance contract. The NAIC prescribed a CRVM for universal life insurance for the first time in December 1983. Thus, reserves for such contracts issued after 1983 must be computed using the prescribed CRVM; reserves for such contracts issued prior to the NAIC recommendation could be computed using the newly prescribed CRVM and would be considered to be computed on a method consistent with CRVM. Also, the NAIC has not prescribed any method for contracts issued by assessment companies in Texas (i.e., either mutual assessment companies or stipulated premium companies), because such life insurance companies generally are not found outside of Texas. Under Texas law, reserves for such policies are computed on a half-year full preliminary term method and such

[21] There is also a special rule (sec. 217(n) of the Act) that allows a company to use the net level reserve method with respect to any noncancellable accident and health insurance contract for any taxable year, if the company (1) uses that method to compute its tax reserves on noncancellable accident and health contracts for such taxable year, (2) was using that method for statutory reserves on noncancellable accident and health contracts as of December 31, 1982 (as evidenced by its 1982 annual statement, as originally filed), and (3) has continuously used that method for reserves on noncancellable accident and health contracts for annual statement purposes after 1982 and through such taxable year. The reference in the qualification requirements to the annual statement filing of a company indicates that this rule was intended to be applied on a company-by-company basis.

This statutory provision was intended to be narrow in its application by requiring a complete and continuous commitment by the company to the use of the more conservative net level reserve method for its directly written noncancellable accident and health contracts as a reflection of the company's conservative business practices before a company could recognize such practices for tax purposes. Specifically, it was intended to address the factual situation of a company that had followed, and continues to follow, the business practice of computing all its reserves for directly written noncancellable accident and health contracts on a net level basis for State purposes and to allow such a company to use this more conservative reserve basis for tax purposes. It was intended that a company be considered to have all its directly written accident and health reserves on a net level basis even if *de minimis* amounts (i.e., no more than 1 percent) do not so conform. With respect to reserves for contracts covered by a reinsurance agreement a reinsuring company generally adopts the reserve method used by the ceding company and does not follow the usual reserve business practice it would use for directly written business. Accordingly, for purposes of applying this special rule and qualifying therefor, only reserves on directly written contracts were intended to be taken into account.

Because this special rule is a departure from the general tax policy adopted in statutorily prescribing life insurance tax reserves, and because of a concern that the rule be strictly narrow in its scope, the statement of managers for the conference report included additional explanatory language. The additional explanation limited the application of the rule to noncancellable accident and health contracts sold under currently marketed plans of insurance, but not under new plans of insurance. The practical consequences of this further limiting language is that no company, even one meeting the otherwise strict qualification requirements, will elect to use the special rule because the detriment of forgoing the fresh start (because noncancellable accident and health reserves are not revalued) will not be offset by any favorable future reserve treatment for new product developments. Such an explanation is inconsistent with the clear intention to allow certain companies with conservative reserve business practices to recognize those reserve practices for tax purposes. Thus, the election of the special rule must have been intended to apply for business under both existing and new plans of insurance. Given this understanding, it is anticipated that appropriate technical corrections will be made to clarify the application of this special rule.

method should be considered to be consistent with CRVMs prescribed by the NAIC.[22]

The new provision specifies that the reserve methods prescribed do not incorporate any provisions which increase the reserve because the net premium (computed on the basis of Federally prescribed assumptions) exceeds the actual premiums or other consideration charged for the benefit. Thus, the computation of the tax reserves will not take into account any State law requirements regarding "deficiency reserves" (whether such reserves are as defined under prior law or whether the NAIC prescribed method otherwise requires a company's reserves to reflect a gross premium charge that is less than the net premium based on minimum reserve standards).

In general, the Federally prescribed reserve methods refer to those recommended by the NAIC for the particular type of contract. There is no requirement that the method also be required based on the prevailing view of the States. Thus, as a general rule, in computing any life insurance reserve, a company must take into account any factors specifically recommended by the NAIC. If specific factors are not recommended by the NAIC prescribed reserve method, the prevailing State interpretation of such method should be considered for purposes of determining what factors can be taken into account in applying the computation method for tax purposes.

With respect to the computation of annuity reserves, it was understood that the practices of the various States differ on whether surrender charges should be taken into account (and reduce the amount of the reserve) and that the matter is currently being considered by the NAIC for a recommendation. In light of these events, the Congress specifically intended that, in the case of annuity reserves, if the NAIC acted in 1984 and clarified that surrender charge factors are to be disregarded (and not to reduce the amount of the reserve) under the CARVM for certain contracts, then this clarification is to be considered in effect on the date of issuance of such contracts. It was recognized that giving retroactive effect to a NAIC recommendation in this instance is an exception to the general rule that reserves must be computed for tax purposes under the method prescribed by the NAIC (or the prevailing State interpretation thereof) in effect on the date of issuance of the contract.

Interest rates

With respect to the assumed interest rate to be used in computing the Federally prescribed reserve, the Act looks to the "prevailing view" of the States. A view is considered to be a prevailing view if it is recognized by at least 26 States when the contract is

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[22] An exception from the general mortality and morbidity tables requirements for reserves for life insurance contracts issued by assessment companies is also provided as a nonCode amendment. These companies may use the table used for State law purposes if that mortality and morbidity table was developed by taking into account the particular experience of those companies and was in existence and in use by 1965. Further revisions of such unique tables will be allowed for tax purposes only if the table is revised in a manner consistent with the way in which the original table was developed. Finally, there is a nonCode amendment that allows mutual assessment companies in Texas to use their statutory reserves for tax purposes (sec. 217(f) of the Act).

issued.[23] Thus, the "prevailing State assumed interest rate" means, for any contract, the highest assumed interest rate permitted to be used in at least 26 States in computing life insurance reserves for insurance or annuity contracts of that type as of the beginning of the calendar year in which the contract is issued. If the highest assumed interest rate is actually determined by the States during the year but declared effective as of the beginning of the calendar year, that rate also will be effective for tax purposes at the beginning of the year. For nonannuity contracts, the issuing company may elect, on a contract-by-contract basis, to use the prevailing interest rate from the preceding calendar year. In determining the highest assumed rates permitted in at least 26 States, each State should be treated as permitting the use of every rate below its highest rate. Also, the highest State assumed interest rate referred to in the Act is the highest permitted to be used in computing reserves without taking into account any limitations that might be imposed by States if a different rate is assumed for computing cash surrender values under standard nonforfeiture laws.

Also, a special rule was adopted for purposes of identifying the prevailing interest rate with respect to life insurance reserves on noncancellable accident and health insurance contracts (e.g., the reserve in addition to the unearned premiums and unpaid losses on such contracts). Until States specifically prescribe an interest rate for these reserves, the prevailing interest rate for reserves on whole life policies will be used because of the analogous character of these reserves to reserves on ordinary life policies.

Mortality tables

Like the prescribed interest rate, the prevailing commissioners' standard tables for mortality or morbidity to be used for computing the Federally prescribed reserves are, with respect to any contract, the most recent tables prescribed by the NAIC and permitted to be used for that type of contract in computing reserves under the laws of at least 26 States when the contract is issued. If a table becomes a prevailing commissioners' standard table during a calendar year, the Congress intended that the new table could be used as the prevailing table from the beginning of the calendar year (this does not alter when the year of change occurs). Generally, when mortality and morbidity tables are being updated and adopted by the States, companies will have three full years after a particular set of tables becomes the prevailing view of the States before such table becomes mandatory for computing reserves for tax purposes. For example, it is the understanding of the Congress that the 1980 C.S.O. tables for life insurance contracts were adopted by at least 26 States by the end of 1983. Thus, companies will be able to use either the 1958 C.S.O. tables or the 1980 C.S.O. tables for taxable years 1984, 1985, and 1986 for computing tax reserves; however, the

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[23] In the case of reinsurance under which the future liability of the reinsurer is determined on the basis of the separate experience of underlying policies (rather than the overall experience of a block of business), the issue date appropriately referred to for these purposes is that of the underlying policies and not the date of the reinsurance contract.

1980 C.S.O. tables will have to be used for contracts issued after 1986.

The Federally prescribed reserve requires the use of the prevailing commissioners' standard tables for mortality and morbidity adjusted as appropriate to reflect the risks, such as substandard risks, incurred under the contract which are not otherwise taken into account. If, for example, the commissioners' standard tables differentiate between smokers and nonsmokers, reserves relating to insureds that are otherwise standard risks except for known smoking habits must be computed using the commissioners' standard table for smokers without any adjustment to reflect substandardness due to smoking. This is appropriate because the factor of smoking is already taken into account, and any excess mortality due to such factor is implicit in the use of the smokers' table. Companies may adjust the prevailing commissioners' standard tables, as appropriate, to reflect risks incurred under the contract if such risks are not otherwise taken into account. For example, a company may use an appropriate multiple of a table to reflect the substandard classification of particular insureds because of poor health or medical condition. An appropriate multiple should reflect the greater mortality expected, for example, from a person with a known heart or diabetic condition, in excess of the mortality of the group of standard insureds that is implicit in the prevailing commissioners' standard table. Also, adjustment to the tables may be appropriate to reflect the risks involved in writing term insurance on individuals for whom the company requires no evidence of insurability (that is, if the company does not underwrite the risks); [24] or because the insureds reside in a foreign country known to be experiencing civil strife.

The Act also provides special rules for existing contracts where standard tables are not available or where multiple tables (or projections) are available. Generally, if there is no prevailing commissioners' standard table applicable to a contract when it is issued, the table used for purposes of computing the Federally prescribed reserve must be determined under Treasury regulations. However, for contracts issued before 1948 (when the use of commissioners' standard tables was first required), the mortality or morbidity tables used for State law purposes can be used in recomputing all reserves for tax purposes as of January 1, 1984, and thereafter in computing the Federally prescribed reserve. The Act also specifically provides that, if there are multiple mortality and morbidity tables (e.g., projections of the standard table) that meet the definition of the prevailing commissioners' standard table with respect to a certain type of contract, the table that generally yields the lowest reserve must be used in computing the Federally prescribed reserve.

Change in computing reserves

The prior law rule allowing income or loss resulting from a change in the method of computing reserves to be taken into account ratably over a 10-year period is retained under the Act. Gen-

[24] For example, States have recognized that some adjustment is appropriate to the standard table for computing adequate reserves on credit life insurance.

erally, the rule for a change in basis in computing reserves will be applied to life insurance tax reserves only if there is a change in basis in computing the Federally prescribed reserve (as distinguished from the net surrender value). Although life insurance tax reserves now require the use of a Federally prescribed method, interest rate, and mortality or morbidity table, changes in other assumptions for computing statutory reserves (e.g., when premiums are collected and claims are paid) may cause increases or decreases in a company's life insurance reserves that must be spread over a 10-year period. Changes in the net surrender value of a contract are not subject to the 10-year spread because, apart from its use as a minimum in determining the amount of life insurance tax reserves, the net surrender value is not a reserve but a current liability.

Special rules

In addition to the above described rules for computing the Federally prescribed reserves, the Act provides some special rules for life insurance reserves under pension plan contracts, group contracts, certain supplementary benefit provisions, substandard risks, and contracts issued by foreign branches of domestic life insurance companies.

Pension plan and group contracts

For purposes of computing the amount of life insurance reserves for pension plan contracts, the net surrender value of a contract is deemed to be an amount equal to the balance in the policyholder's fund (determined with regard to any penalty or forfeiture imposed upon surrender, but without regard to any market value adjustment). The term "policyholder's fund" refers generally to any experience fund, experience accumulation or asset share allocable to the contract.

For purposes of computing the Federally prescribed reserve for any group contract, the date the contract is issued is generally the date as of which the master plan is issued. However, if a benefit is guaranteed to a plan participant after such date, the company must take into account the date as of which the benefit is guaranteed in computing its reserves.

Finally, there is a transitional rule for recomputation of reserves for group contracts as of January 1, 1984, if the issuance date (or the date benefits were guaranteed) cannot be determined. In such a case, the issuance date must be determined on the basis prescribed by Treasury. It is anticipated that Treasury will develop some method for approximating the date of issuance that generally reflects the pattern of growth in the type of group business.

Supplemental benefits

Under the Act, the amount of the life insurance reserve for certain enumerated supplemental benefits is the statutory reserve. It was believed that, due to the *de minimis* nature of the enumerated supplemental benefit reserves, economic distortions caused by using statutory reserves would be minimal. The supplemental benefits listed are any (1) guaranteed insurability benefit,[25] (2) accidental death or disability benefit,[26] (3) convertibility benefit, (4) disability waiver benefit, or (5) any other benefit prescribed by regulations, if such benefit is supplemental to a contract for which there is a policyholder reserve item taken into account for taxable income purposes. In extending this list, Treasury should consider any supplemental benefits it adds as being *de minimis* either because reserves for such business represent a relatively small portion of total industry reserves or because the tax effect of so enumerating it is minimal. The life insurance reserve for any other benefit provided for under the contract and not specifically so enumerated, whether or not such a benefit is considered supplemental under State law, must be computed using the Federally prescribed method (as described in section 807(d)).

If a supplemental benefit is a "qualified supplemental benefit", the life insurance reserve for such benefit must be computed separately as though such benefit were under a separate contract. A qualified supplemental benefit is a supplemental benefit as listed in the Act, if there is a separately identified premium or charge for such benefit and any cash value (i.e., net surrender value) under the contract attributable to any other benefit is not available to fund such supplemental benefit. The use of any loan provision to pay premiums or charges due for the supplemental benefit is not intended to be construed as making any net surrender value available for the purposes of this provision.

For example, if a contract provides for a qualified supplemental benefit (e.g., accidental death or disability), the net surrender value of the contract is $4,000, and the Federally prescribed reserves are $3,800 for the basic death benefit and $50 for the supplemental benefit, the total reserve for tax purposes will be $4,050 if none of the net surrender value is attributable to the qualified supplemental benefit. In essence, the supplemental benefit is considered a separate contract and the reserve is computed as the greater of the net surrender value or the tax reserve. Suppose, however, the supplemental benefit is not a qualified supplemental benefit because it is provided for under a contract that has a single policy value or fund against which all expenses and costs of insurance are charged. Under such circumstances, the total reserve for tax purposes will be $4,000 because the supplemental benefit will not be considered a separate contract and the amount of the life insurance reserve for the contract is the greater of the net surrender value (i.e., $4,000) or the Federally prescribed reserves amount (i.e., $3,800 + $50).

Substandard risks

The amount of life insurance reserve for any "qualified substandard risk" must be computed as if under a separate contract. A substandard risk is a qualified substandard risk if (1) the insurance company maintains a separate reserve for such risk, (2) there is a

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[25] The term "guaranteed insurability benefit" is intended to include guaranteed annuability benefits.

[26] Because of the intended *de minimis* nature of the listed supplemental benefits, a disability income benefit provision (other than one that provides for income payments only to carry the premiums of the policy or some other incidental expenses of the insured) is not intended to be construed as a supplemental benefit.

separately identified premium charge for such risk, (3) the amount of the net surrender value under the contract is not increased or decreased by reason of such risk, and (4) the net surrender value under the contract is not regularly used to pay premium charges for such risk. It was expected that regulations could provide that a provision for the systematic borrowing based on the net surrender value of the contract to pay both the basic premium and the substandard charge will be considered to disqualify the substandard risk in certain situations. However, loan provisions that are not actually used on a regular and automatic basis to pay substandard charges will not result in disqualification of the substandard risks.

The amount of the life insurance reserve determined for any qualified substandard risk will in no event exceed the sum of the separately identified premium charges for such risk plus interest, less mortality charges. The aggregate amount of insurance in force under contracts to which these special rules for substandard risks can apply cannot exceed 10 percent of insurance in force (other than term insurance) under life insurance contracts of the company. The substandard classification of any insurance in force in excess of 10 percent can only be taken into account through an appropriate adjustment to the prevailing commissioners' standard table in computing the Federally prescribed reserve. Also, if a company computes a separate substandard reserve under the qualified substandard risk provision, the mortality assumption for purposes of computing the reserve for the basic benefit cannot take into account any substandard risk factors.

Term life insurance and annuity benefits

The Act provides a special rule for contracts issued before January 1, 1989 under plans of insurance in existence on March 15, 1984, for purposes of computing tax reserves with respect to riders for term life insurance and annuity benefits. Term life insurance and annuity benefits included in such insurance contracts will be treated as qualified supplemental benefits, for purposes of allowing the tax reserve to be computed for such benefits as though each benefit were a separate contract. However, these benefits will not be treated as qualified supplemental benefits for purposes of using the statutory reserve as the tax reserve for such benefit because riders for term life insurance and annuity benefits generally may not be *de minimis* like the specifically enumerated qualified supplemental benefits (see discussion above). Accordingly, the reserves for such benefits will be computed under the general reserve rules, as the greater of the net surrender value or the Federal tax reserve, rather than (as with other qualified supplemental benefits) the reserves used on the annual statement. Also, to be treated as a qualified supplemental benefit, the riders for the term life insurance and annuity benefits must meet all other requirements for such treatment (that is, there must be a separately identified premium or charge for such benefit and any cash value under the contract attributable to any other benefit must not be available to fund such benefit).

Reserves under foreign law

There is a special rule which allows domestic life insurance companies to recognize, in lieu of the Federally prescribed reserve, the minimum reserve required by the laws, regulations, or administrative guidance of the regulatory authority of a noncontiguous foreign country if (1) the reserves arise out of life, accident or health insurance contracts issued to residents of the foreign country and (2) the foreign country requires the domestic company (as of the time it began operations in the foreign country) to operate in such country through a branch. The reserve cannot exceed the net level reserve for a contract as determined using NAIC standards and the interest rates and mortality tables used in the contract.

Variable contracts (new sec. 817)

The Act continues to provide special rules for variable annuities and contracts with reserves based on segregated asset accounts, but conforms the tax treatment of such contracts to that of variable pension plan contracts under prior law and extends those rules to variable life insurance contracts. Thus, with respect to any variable contract, the reserve items taken into account at the close of the taxable year for purposes of determining net increases or net decreases must be adjusted by subtracting any amount attributable to appreciation in the value of assets or by adding any amount attributable to depreciation. Such adjustments for appreciation or depreciation are to be made whether or not the company has disposed of the assets during the taxable year.[27] The company's basis in the assets underlying all variable contracts also will be adjusted for appreciation or depreciation, to the extent the reserves are adjusted. Thus, corporate level capital gains and losses, and the tax effect thereof, are eliminated. This basis adjustment provision generally conforms the tax treatment of all variable contracts to that of variable pension plan contracts under prior law.

The Act adopts a provision that grants the Secretary of the Treasury regulatory authority to prescribe diversification standards for investments of segregated asset accounts underlying variable contracts. The diversification requirement was provided in order to discourage the use of tax-preferred variable annuities and variable life insurance primarily as investment vehicles. The Congress believed that a limitation on a customer's ability to select specific investments underlying a variable contract will help ensure that a customer's primary motivation in purchasing the contract is more likely to be the traditional economic protections provided by annuities and life insurance. The Congress anticipated that any regulations prescribing diversification standards changing current practice will have a prospective effective date.

The Act defines the range of the diversification requirements within which Treasury has authority to set standards by specifical-

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[27] In addition to the adjustment of reserves for variable contracts, an adjustment is provided for any appreciation or depreciation during a year affecting deductions for death claims, etc., under section 805. This adjustment will apply only to the extent of such appreciation or depreciation, and not in the greater amount that such appreciation or depreciation affects death benefits. Thus, if under a variable life insurance contract, appreciation in the value of separate account assets of $100 increased death benefits by $200, the amount of the adjustment to death benefits on account of this provision is $100.

ly providing that any segregated asset account that is at least as diversified as one satisfying the requirements of a regulated investment company under section 851(b) will be considered to be adequately diversified without further showing, if the account has no more than 55 percent of its assets held in cash, cash items, Government securities, or securities of other regulated investment companies. There is also an exception that allows variable life insurance to be based on a segregated asset account fully invested in securities issued by the Treasury. For purposes of meeting the diversification requirements prescribed by Treasury or the regulated investment company safe harbor, ownership by a segregated asset account of beneficial interests in a regulated investment company will not be treated as a single investment (but will be considered to have the diversification of the underlying fund) so long as all shares of the underlying fund are owned by one or more segregated asset accounts of insurance companies. Although not clear in the statute, a similar rule was intended with respect to variable life insurance based on Treasury securities. That is, a segregated asset account can invest in a fund of Treasury securities in which all the beneficial interests are owned by insurance companies or the segregated asset account underlying the variable life insurance contract can own the Treasury securities directly.

The adoption of diversification requirements and the limitation of the "look through" rule to situations in which access to an underlying fund is available exclusively through the purchase of a contract from an insurance company are directed toward preventing the use of publicly available funds for variable contracts. Thus, generally, ownership of shares by an insurance company for its general account or by the fund organizer (e.g., at the start of the fund because seed money has been used or for administrative convenience in operating a fund) will not be a violation of the requirement for diversification. The fact that a similar fund is available to the public will not cause the segregated asset fund to be treated as being publicly available. Finally, the Act specifically provides that a company may use an independent investment advisor with respect to the segregated asset accounts underlying their variable contracts.

In authorizing Treasury to prescribe diversification standards, the Congress intended that the standards be designed to deny annuity or life insurance treatment for investments that are publicly available to investors and investments which are made, in effect, at the direction of the investor. Thus, annuity or life insurance treatment will be denied to variable contracts (1) that are equivalent to investments in one or a relatively small number of particular assets (e.g., stocks, bonds, or certificates of deposit of a single issuer); (2) that invest in one or a relatively small number of publicly available mutual funds; (3) that invest in one or a relatively small number of specific properties (whether real or personal); or (4) that invest in a nondiversified pool of mortgage-type investments. This new diversification authority should require a diversification of issuer related to the assets for the variable contract and was not intended to allow the imposition of any requirement that the investment fund reflect a diverse range of investment goals (e.g., short-term, long-term, or fixed income/equity securities need not be mixed in a single fund). This diversification requirement will not apply to funds underlying pension plan contracts defined under new section 818.

If the segregated asset account does not meet the prescribed diversification standards, then a variable contract based on the account will not be treated as an annuity, endowment, or life insurance contract for purposes of subchapter L (relating to taxation of insurance companies), section 72 and section 7702(a) (relating to the definition of a life insurance contract). A variable contract will cease to be treated as an annuity, endowment or life insurance contract when and if the underlying fund fails to be adequately diversified. Apart from meeting the diversification standards, whether a contract is a variable contract depends on the terms of the contract. Generally, the fact that the benefits do not vary for a period of time because the value of the underlying assets has not changed or a minimum death benefit guarantee is in operation will not cause a contract to cease being treated as a variable contract.

The Act also continues the separate accounting requirements under prior law for various income, exclusion, deduction, asset, reserve, and other liability items properly attributable to variable contracts. For example, with respect to variable contracts, the company's share of dividends received, and the policyholders' share of tax-exempt interest (which reduces the closing balance of the reserves), will be determined with reference to the income and deduction items attributable to the underlying separate account. Likewise, the equity base of the separate account will be determined under the separate accounting requirement and aggregated with the company's average equity base for its general account business.

In addition, Treasury has regulatory authority (under an amendment to sec. 514) to subject to tax the assets of a segregated asset account if the account is used to circumvent the acquisition indebtedness rules.

e. Policyholder dividends (sec. 211 of the Act and new secs. 808 and 809 of the Code) [28]

Prior Law

In general, under present and prior law, policyholder dividends are dividends and similar distributions to policyholders. Interest paid and return premiums are not policyholder dividends. This statutory language had been expanded in regulations so that the term policyholder dividends generally referred to amounts returned to policyholders that were not fixed in the contract and depended on the experience of the company or the discretion of management. However, taxpayers have taken the position that the term did not include excess interest (i.e., amounts in the nature of interest that are paid or credited to policyholders and are determined at a rate in excess of the rate used under the contract for

[28] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 211; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1420-1426; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 211; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 547-553; and H. Rep. No. 98-861 (June 23, 1984), pp. 1056-1059 (Conference Report).

purposes of computing the company's reserve deduction) even though such amounts were not fixed in the contract but depended upon the experience of the company or the discretion of management.

Under prior law, policyholder dividends paid by mutual and stock life insurance companies were deductible at the company level. Special rules applied, however, to limit the amount of this deduction. Under the permanent provisions of the 1959 Act, the deduction for policyholder dividends (and certain other special deductions) was limited to the excess of gain from operations over the taxpayer's taxable investment income plus a statutory amount of $250,000. Under temporary provisions added to the Code in TEFRA and applicable in 1982 and 1983, the deduction was limited to either (1) an amount computed under the 1959 Act rule with the $250,000 statutory amount increased to $1 million, phasing down to zero as the sum of the company's policyholder dividends and other special deductions increased from more than $4 million to $8 million, or (2) an amount equal to the statutory amount (as modified), plus 100 percent of dividends on pension business, plus 77½ percent of nonpension policyholder dividends for mutual companies (85 percent for stocks). Under prior law, policyholder dividends were accounted for on a reserve basis, and a company was allowed to deduct additions to its policyholder dividend reserves for dividends that were payable during the year following the taxable year.

Explanation of Provisions

As under prior law, the Act allows a deduction for dividends or similar distributions to policyholders. The Act departs from prior law, however, in that the amount of the deduction for any taxable year is the amount of policyholder dividends paid or accrued during the taxable year rather than the amount of the increases in the reserves for policyholder dividends that are payable during the year following the taxable year. Under a transitional rule, this change from a reserve to an accrual method is not to be treated as a change in a method of accounting. Thus, no income or loss is to be recognized with respect to amounts in existing policyholder dividend reserves.

This "fresh start" was granted with respect to the accounting change for policyholder dividends, on the assumption that insurance companies would continue to follow their general business practice in declaring policy dividends at the end of a year to be payable on policy anniversaries during the following year. It was understood that, given the general business practices, the change in policy dividend accounting has the effect of delaying the deduction for policyholder dividends to the taxable year in which they are paid. It appears that by guaranteeing policy dividends on termination, which may not change necessarily the payment date of policy dividends, or by changing the payment date by making policy dividends available upon declaration, a company can accelerate the deduction for approximately one-half the policyholder dividends that would have been deducted in the following taxable year if there had been no change in the company's business practices in declaring policy dividends. As a practical matter, the amount of the acceleration of the policyholder dividend deduction could be viewed as restoring a company, in part, to the position it enjoyed under prior law with respect to the timing of the policyholder dividends deduction. The "fresh start" for the change in policyholder dividend accounting was intended to mitigate the detriment caused taxpayers by the statutory change in such accounting; to the extent the detriment caused by the statutory change is mitigated in fact by a company's own change in business practices, the "fresh start" was not intended to give a company additional tax benefits.

Policyholder dividends defined (new sec. 808)

The Act adopts a broad definition of the term policyholder dividends to include any distribution to a policyholder that is the economic equivalent of a dividend. Thus, in addition to any amount paid or credited to policyholders (including an increase in benefits) when the amount is not fixed in the contract but depends on the experience of the company or the discretion of management, the term policyholder dividends specifically includes excess interest, premium adjustments, and experience-rated refunds. In this regard, the Act corrects a possible deficiency of prior law which may have permitted companies to avoid the limitations on policyholder dividends through the use of excess interest and experience-rated refund products rather than traditional dividend paying products.

The term excess interest means any amount in the nature of interest that is paid or credited to a policyholder and determined at a rate in excess of the prevailing State assumed interest rate for the contract (i.e., the rate used under the Act for purposes of determining the amount of the company's Federally prescribed reserve under the rules contained in new section 807(d)). Amounts in the nature of interest include all amounts paid for the use of money regardless of the particular designation adopted by the payor or payee. Thus, amounts in the nature of interest include interest payments with respect to amounts left on deposit and amounts paid in lieu of interest such as in the case of origination or service fees. Similarly, amounts in the nature of interest include amounts calculated as interest such as the increase in reserves or cash surrender values attributable to assumed or guaranteed interest rates rather than premium contributions. Thus, for example, any increase in the cash surrender value of a contract above that which would result if the prevailing State assumed interest rate were used to compute the increase is treated as excess interest.

The term premium adjustment means any reduction in the premium under an insurance or annuity contract which, but for such reduction, would have been required to be paid under the contract. If no premium amount is fixed in the contract, variations in premiums paid during the course of the contract are not considered premium adjustments. Further, a change in the amount of a premium that is attributable to the insurability of the insured is not considered a premium adjustment.

Finally, the term experience-rated refund means any refund or credit based on the experience of the contract or group involved. Thus, for example, if a company sells a group policy to an employer covering the lives of its employees and the premiums received exceed the sum of the claims paid and other expenses, any refund of such excess is an experience-rated refund. The Act also adopts the general rule that any policyholder dividend that increases any of the benefits payable under the contract (including the cash surrender value), or reduces the premium otherwise required, is treated as paid to the policyholder and returned by the policyholder to the company as a premium.

Reduction of certain deductions of mutuals (new sec. 809)

Although the general rules and definitions relating to policyholder dividends apply to stock and mutual life insurance companies alike, for mutual companies the amount of the deduction for policyholder dividends is reduced by an amount referred to in the Act as the "differential earnings amount." If the differential earnings amount exceeds the allowable deduction, then the excess will reduce the closing balance of the company's reserves. This reduction reflects the Congress' recognition that, to some extent, policyholder dividends paid by mutual companies are distributions of the companies' earnings to the policyholders as owners.

Because a mutual company's policyholders are also the owners of the enterprise, policyholder dividends paid to them are distributions from the company that are a combination of price rebates, policyholder benefits and returns of company profits. Although there is no precise way to segregate a policyholder dividend or other payment into these various components, the Congress believed that profit-oriented enterprises tend to distribute earnings to their owners in amounts that are proportional to the owners' equity in the business. Thus, the Congress believed that the portion of a policyholder dividend that is a distribution of earnings can be measured as a percentage of the mutual company's equity (the "average equity base"). To determine the appropriate percentage of the equity base, the post-dividend rates of return on equity for both stock and mutual companies were examined. The average post-dividend, pre-tax return on equity of mutual companies falls below that for a comparable group of stock companies. The Congress believed that this difference is attributable to distribution by mutual companies of earnings to their owners.

As mentioned above, under the Act, this theoretical approach to identifying ownership distributions by a mutual company is given effect by means of a reduction in the policyholder dividends deduction by a "differential earnings amount". This amount is computed by multiplying the company's average equity base for the taxable year by the "differential earnings rate" for the taxable year. The differential earnings rate is the excess of the "imputed earnings rate" over the "average mutual earnings rate". As explained below, the "imputed earnings rate" is set in the Code (and subsequently adjusted) to provide comparable treatment for stock and mutual companies.

Imputed earnings rate

The imputed earnings rate for 1984 is 16.5 percent. For taxable years beginning after 1984, the imputed earnings rate will be an amount which bears the same ratio to 16.5 percent as the current stock earnings rate (i.e., the numerical average of the rates of return for the 50 largest stock life insurance companies for the three years preceding the taxable year) bears to the base period stock earnings rate (i.e., the numerical average of the rates of return for the 50 largest stock companies for 1981, 1982, and 1983).

The Congress anticipated that this 16.5-percent rate will result in the mutual segment of the industry bearing 55 percent of the aggregate industry tax burden for 1984. The Congress believed that this is appropriate in the light of a number of factors including the historic allocation of the industry's tax burden, the relative percentages of assets held by the stock and mutual segments of the industry and the difference in treatment of mutual company policyholders and stock company shareholders.[29] Since the Congress believed that the 16.5-percent rate results in an appropriate allocation of the industry's tax burden for 1984 given these various factors, it decided to adjust this rate in proportion to changes in the rate of return for large stock companies and not simply to replace the imputed rate with one equal to the actual rate of return of a group of stock companies in subsequent years. Specifically, the imputed earnings rate is indexed to changes in the current stock earnings rate as compared to the average of the stock earnings rates for a base period of calendar years 1981, 1982, and 1983.

Stock earnings rate

The stock earnings rate for any particular year is the numerical average of the earnings rates of the 50 largest stock life insurance companies. The numerical average of stock earnings rates is used in order to reduce the potential impact of any manipulation of the rate by a few large stock companies. The three-year period is used to preclude the possibility of sharp rises or declines in the rate of return for the stock segment of the industry, giving the mutual companies some ability to plan for and predict tax costs for purposes of marketing their products. The 50 largest stock companies are to be determined by the Secretary of the Treasury on the basis of gross assets. For purposes of ascertaining the 50 largest companies and their earnings rates, assets of a company among the 50 largest will be aggregated with assets of any affiliated life companies (i.e., affiliated groups will be treated as one company).

Average mutual earnings rate

The average mutual earnings rate for any year is the weighted average of the rates of return for all mutual companies. The use of an aggregate or weighted average reflects the structure of the ownership differential provision which, in effect, views the entire mutual segment of the life insurance industry as a taxpaying "entity" required to bear approximately 55 percent of the industry tax burden. The aggregate mutual life insurance company tax burden is statutorily prescribed by the imputed earnings rate of 16.5% on equity for 1984 (and as thereafter indexed). The use of a weighted average mutual earnings rate to determine the differen-

[29] Earnings that are distributed by a stock company to its shareholders are included in income by the shareholders. In contrast, in the case of a mutual company, earnings that are distributed are not included in income by the policyholders.

tial earnings rate ensures that the regular tax (computed without the ownership differential provision and assuming no tax preference items), plus any increase in tax owed due to the application of the ownership differential provision, will meet the prescribed aggregate mutual company tax burden.

Also, the use of a weighted average tends to prevent manipulation by large mutual companies of their individual company's tax liability through payment of overly large amounts of policyholder dividends because it could substantially increase the differential earnings rate and the large companies' share of the adjustment in the following year.

Computation of earnings rates

The earnings rate for any life insurance company is to be determined by the Secretary of the Treasury by reference to a company's statement gain or loss from operations as a percentage of its average equity base.

The statement gain or loss from operations for a company means the net gain or loss from operations set forth in the annual statement, determined without regard to Federal income taxes and with further adjustments for certain tax items. First, the statement gain or loss from operations must be adjusted by substituting for the amount shown on the annual statement for policyholder dividends the amount of the deduction for policyholder dividends under new section 808, unreduced by any differential earnings amount (i.e., without regard to new sec. 808(c)(2)). This required adjustment can be illustrated by the following example: Assume that mutual life insurance company *M* reported on its 1984 annual statement the payment of $20 million in policyholder dividends and a provision of $12 million for dividends to be paid in the following year ($1 million of which was accrued for tax purposes by the close of 1984). Assume further that of the $21 million in policyholder dividends paid or properly accrued, *M* was allowed (after the reduction for a differential earnings amount) a deduction for policyholder dividends of $19 million for 1984. In taking into account *M*'s "statement gain or loss from operations" in computing the average mutual earnings rate, the Secretary must deduct the $21 million of dividends paid or accrued from *M*'s net pre-dividend gain or loss from operations set forth on its 1984 annual statement. The fact that only $19 million of the $21 million was deductible by *M* in computing its taxable income is irrelevant. Second, statement gain or loss from operations must be determined on the basis of tax reserves rather than statutory reserves. Third, the statement gain or loss from operations must be properly adjusted for realized capital gains and losses, and other relevant items.

In calculating the stock earnings rate or the average mutual earnings rate, the Secretary is to take into account companies that may be operating at a loss and, in effect, have a negative rate of return, as well as companies that are operating on a profitable basis. However, in order to eliminate distortions in the computation of the average earnings rate of the 50 largest stock companies, the Secretary has the authority to omit companies with aberrational rates caused by disproportionately small equity bases (for example, when a company is close to being or is insolvent).

Further, the authority granted the Secretary to determine the rate of return includes authority to disregard or recharacterize a transaction determined by the Secretary to have been engaged in principally to manipulate the imputed earnings rate or the differential earnings rate. For example, if a noninsurance parent company with a life insurance subsidiary makes a substantial capital contribution to its stock life insurance subsidiary during the taxable year (but such amount is not reflected in the assets at the beginning or end of the year), the Secretary could compute the stock earnings rate for the subsidiary without taking into account the amount contributed by the parent or the income generated by such amount if the Secretary determined that the contribution was principally intended to enable the life insurance subsidiary to manipulate its rate of return. In making this determination, the Secretary should consider such factors as the existence of any nontax business purpose for the transaction and the reasonable needs of the subsidiary for capital.

The structure of the Act requires the collection of data and information from both stock and mutual life insurance companies to implement the ownership differential provisions. This is unique in that data may be required from a stock company for past as well as current and future taxable years, and such data will not affect the determination of its own tax liability but rather will be necessary to determine the tax liability of mutual companies. In order to avoid disputes about whether Treasury can collect the necessary information for past taxable years, with the attendant authority to audit the information and assess penalties for failure to file or for providing false information, section 219 of the Act specifically clarifies that Treasury has authority to require the relevant stock or mutual life insurance companies to submit information returns from which Treasury will be able to ascertain data necessary for it to implement the ownership differential provisions, even with respect to tax years beginning before 1984.

Average equity base

The average equity base of a stock or mutual company is the average of (1) the equity base determined as of the close of the taxable year, and (2) the equity base determined as of the close of the preceding taxable year. For purposes of computing a company's average equity base for a taxable year beginning in 1984, the equity base for 1983 and preceding years will be computed under the rules contained in the Act as if the Act were in effect for such year. The term equity base means an amount equal to the statutory surplus and capital plus any nonadmitted financial assets,[30] the excess of statutory policy reserves over tax reserves,[31] the amount of any

[30] A special rule (section 217(j) of the Act) is provided for certain mutual life insurance companies that are successor companies to fraternal benefit societies. Under this provision, the mutual life insurance company can reduce its average equity base by the present value of the statutory surplus assumed from its predecessor fraternal benefit society. The present value of the statutory surplus will be determined using a 7 percent interest rate for taxable years before 1984 and using the average mutual earnings rate for taxable years 1984 and following. The application of this provision is limited to mutual life insurance companies that assumed the surplus of a fraternal benefit society in 1950 or in March 1961.

[31] The Act contains a special transition rule (new sec. 809(g)(6)) for determining the average equity base for a mutual life insurance company with a subsidiary issuing excess interest life

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mandatory securities valuation reserve, the amount of any deficiency reserve or any voluntary reserve, and 50 percent of the amount of any provision for policyholder dividends (or other similar liability) payable in the following taxable year.[32]

The term nonadmitted financial asset does not include due and accrued investment income reported as a nonadmitted asset, investments in office furnishings or fixtures, or agents' balances owed to the company. Thus, for example, an amount of due and accrued interest on defaulted bonds is not a nonadmitted financial asset, even though the underlying defaulted bond may be a nonadmitted financial asset. In determining the excess of statutory reserves over tax reserves, the amount of statutory reserves should not include any amount attributable to deferred and uncollected premiums that have not yet been included in life insurance gross income.

Also, the reference to an adjustment for voluntary reserves is not limited to reserves for potential or unaccrued liabilities relating to insurance contracts. It is anticipated that Treasury regulations will provide guidance for classifying reserves as voluntary. For example, a reserve for Federal taxes may be in whole or in part a voluntary reserve. If the reserve is for a Federal income tax liability that might arise in the future if certain items are identified on audit, such a reserve will be treated as a voluntary reserve because liability for those amounts is contingent on detection of the tax issue, assertion of a deficiency, and resolution of the issue. If the reserve is for taxes accrued and payable on the due date of the return for the year, it will not constitute a voluntary reserve. In cases that are less clearcut, such as when the reserve is for deficiencies that have been asserted after audit, the Secretary has authority to give further guidance on whether the reserve is voluntary.

"The provision for policyholder dividends payable in the following taxable year" refers generally to the total amount set aside on the annual statement for apportioned and unapportioned dividends. Only 50 percent of this amount is added to the average equity base because it was believed that, on average, only 50 percent of the total annual statement provision for policyholder dividends to be paid in the following year (whether accrued or unaccrued for tax purposes at the end of the taxable year) is fairly allo-

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insurance contracts. For purposes of determining the excess of statutory policy reserves over tax reserves, the tax reserves may be computed without regard to the accounting rule that prohibits a company from taking into account amounts in the nature of interest that are in excess of the prevailing State assumed interest rate and guaranteed beyond the end of the taxable year (see explanation of the accounting rule in new sec. 811(d)). This rule will apply to reserves for life insurance contracts issued prior to January 1, 1985, under plans of life insurance in existence on July 1, 1983. For these narrow purposes, any change in the contract that requires approval by the State insurance department or that changes the form and timing of amounts credited will be considered a change in the plan of insurance. Thus, a company cannot change a traditional participating policy with policyholder dividends payable on the policy anniversary to an excess interest contract with excess interest guaranteed for a period in advance in order to qualify for the special transition rule for excess interest life insurance contracts.

[32] Under a special rule (new sec. 809(g)(5)) the equity base of any mutual life insurance company can be reduced by that portion of the equity base attributable to the life insurance business that is properly allocable to reserves or liabilities for life insurance contracts issued on the life of residents of Western Hemisphere countries that are noncontiguous to the United States. The equity that is properly allocable to such contracts is the same proportion as the reserves for such contracts bears to the total tax reserves on life insurance contracts (if that proportion is at least 1 to 20). This special equity base modification recognizes that a company may need to maintain higher levels of surplus because of the special classification or substandard nature of certain insureds living in foreign countries undergoing civil strife.

cable as a liability for the current year. Although a policyholder dividend may be paid at the end of a policy year, and not accrue for tax purposes until payment, recognition of part of that dividend as a current liability to determine the equity of the company recognizes that a dividend that is paid, in theory, accrued to the policyholder in a financial sense over the entire policy year. Once the policyholder dividends have actually been paid (for example, amounts left with the company as dividends on deposit and amounts paid back to the company as premiums), such amounts are not included in "the provision for policyholder dividends payable in the following taxable year." Likewise, any amounts set aside for policyholder dividends to be paid beyond the close of the following taxable year are not "payable in the following taxable year" and are included in the equity base in their entirety.

Amounts included in equity under the Act generally refer to and are valued as amounts shown on the annual statement of the company. However, a classification or characterization of an item on a company's annual statement in an attempt to avoid the requirements of the Act will be disregarded. Assume, for example, that a company sets up a separate provision on its annual statement for excess interest that it will distribute in the year following the taxable year. If the provision is not adjusted for in restating annual statement reserves to tax reserves, the provision will be treated as an "other similar liability" payable in the following taxable year, requiring that 50 percent of such amount be included in the equity base.

Differential earnings rate

The differential earnings rate for any taxable year is based on a comparison of the adjusted imputed earnings rate and the average mutual earnings rate for the second preceding year. This rule is necessary because, for any taxable year, the Secretary will not have the data required to determine the average mutual earnings rate prior to the date a mutual company will file its Federal income tax return. However, when actual data becomes available, any difference between the average differential earnings amount for the taxable year and the average differential earnings amount for the second preceding taxable year is to be taken into account as an addition to or deduction from income (before computation of the special life insurance deduction and the small life insurance deduction) for the taxable year during which the Secretary determines the average mutual earnings rate for the prior taxable year.[33] Because any additions to or deduction from income will be taken into account in the first year during which the actual average differential earnings rate can be recomputed, no interest payments are required. If a company ceases to be a mutual insurance company in any year, then any adjustment will have to be taken into account for the taxable year giving rise to the adjustment.

To simplify the administration of the ownership differential provisions for the initial years covered by the Act, the Act substitutes a fixed differential earnings rate of 7.8 percent to be used for pur-

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[33] This recomputation provision (specifically new sec. 809(f)(3)) incorrectly refers to "subsection (c)(2)" rather than to subsection (c)(1)(B)."

poses of filing returns for the 1984 tax year and for estimated taxes for 1985.

Treatment of stock life insurance subsidiaries

Certain modifications to the equity base are required if a mutual life insurance company owns one or more subsidiary life insurance companies. Such subsidiaries are generally treated as stock life insurance companies in computing such subsidiaries' entity level income tax liability. However, for purposes of computing the differential earnings amount, a mutual parent of a subsidiary life insurance company must include the equity of such company in its own equity base (in lieu of the stock of the subsidiary).

For purposes of determining the statement gain from operations of the mutual parent, the mutual parent should ignore any dividends it received from the subsidiary. Also, for purposes of computing the average mutual earnings rate and the imputed earnings rate, life insurance subsidiaries of a mutual life insurance company will be counted as mutual companies. If a subsidiary life insurance company is owned by more than one mutual entity and is not a member of an affiliated group, the Secretary is given regulatory authority to prescribe how proper adjustments should be made in the equity bases of mutual life insurance companies owning stock therein to carry out the general rules described above.

This treatment is in contrast to the treatment of nonlife insurance subsidiaries, the stock of which will be included in the parent mutual company's equity and the earnings of which will only be taken into account in computing the average mutual earnings rate when and as dividends are received by the parent mutual company.

Transition rule for high surplus mutuals

The Act provides a 5-year transition rule for high surplus mutual life insurance companies for purposes of applying the ownership differential provision. A company is a high surplus company if its equity base to asset ratio for 1984 exceeds a specified percentage of assets: 14.5 percent for taxable years beginning in 1984; 14.0 percent for taxable years beginning in 1985 and 1986; and 13.5 percent for taxable years beginning in 1987 and 1988. A high surplus company need not apply the differential earnings rate to the excess portion of its equity base. The amount of any excess equity not taken into account in applying the differential earnings rate will decrease ratably each year, until 1989 when the entire equity base of a high surplus company is subject to the differential earnings rate. The amount of excess equity taken into account by any mutual life insurance company for any year (before being phased down ratably over the 5-year period of the transitional rule) cannot exceed the amount of the excess equity determined for 1984.

For purposes of determining whether a company is a high surplus company and the amount of excess equity, the assets taken into account in the equity to asset ratio include all assets (e.g., certain nonadmitted assets) taken into account in determining its equity base including any additional equity attributed to the mutual because of the rules for the treatment of stock life companies owned by mutual life insurance companies. Thus, all the assets of any life insurance subsidiary whose equity is included in the equity of the parent mutual company, as well as any assets of separate asset accounts, are included in assets for purposes of applying the high surplus transitional rule. Payables and receivables between the parent and life subsidiaries should be ignored, but the same items between the parent and a nonlife subsidiary should be taken into account. Also, the rule against double counting should be observed generally in this area. Thus, for example, if a company purchases bonds at the end of the year and carries a suspense account for the amount of the consideration to be transferred, the value of the bonds should be included in assets and the amount of the suspense account should not.

f. Operations loss deduction (sec. 211 of the Act and new sec. 810 of the Code) [34]

Prior Law

Generally, operations losses may be carried back to each of the 3 taxable years preceding the loss year and may be carried over to each of the 15 taxable years following the loss year. For a life insurance company that qualifies as a new company in the loss year, the 3-year carryback may be added, instead, to the 15-year carryover.

Explanation of Provision

The operations loss deduction provided in the Act is substantially the same as that in section 812 of prior law. New section 810 is treated as a continuation of prior law section 812. Modifications are made that will conform the definition of an operations loss deduction to the new method for determining life insurance company taxable income. In both the Act and prior-law section 812, the operations loss deduction is consistent with the general treatment for a net operating loss in section 172.

The operations loss deduction for any taxable year is defined as the excess of life insurance deductions (which are described in section 804, above) over life insurance gross income (which is defined in section 803, above). The loss from operations for any taxable year may be carried back 3 taxable years and carried over 15 years, just as under prior law. The 18-year carryover for a new life insurance company, as well as the definition of a new life insurance company, are unchanged from prior law. Other rules, relating to the amount of carrybacks and carryovers and the election for operations loss carrybacks (i.e., to relinquish the entire carryback period), also remain unchanged from prior law.

No change has been made in the modifications to the computation of the loss from operations, which modifications exclude the carrybacks and carryovers of the operations loss deduction from the computation of life insurance taxable income and also relate to the limitation on the aggregate amount of dividends received deduction.

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[34] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 211; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1426-1427; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 211; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 553-554; and H. Rep. No. 98-861 (June 23, 1984), pp. 1059-1060 (Conference Report).

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The operation of new section 810 may be illustrated by the following example. Assume that company A has the following results for 1984, 1985, and 1986:

	1984	1985	1986
Tentative LICTI	100,000	200,000	200,000
Small company deduction (sec. 806(b))	(60,000)	(120,000)	(120,000)
Special life company deduction (sec. 806(a)	(8,000)	(16,000)	(16,000)
Taxable income	32,000	64,000	64,000

Assume further that for 1987 and 1988, company A had losses from operations of $150,000 and $200,000, respectively. Under new section 810, the results will be as follows:

	1984	1985	1986
Taxable income	32,000	64,000	64,000
Small company deduction	60,000	120,000	120,000
Special life company deduction	8,000	16,000	16,000
Offset amount	100,000	200,000	200,000
1987 carryback	(100,000)	(50,000)	
1988 carryback		(150,000)	(50,000)
Taxable income after carryback	0	0	150,000

Thus, in 1986, the tentative LICTI for purposes of recomputing the small company deduction and the special life insurance company deduction is $150,000 after carryback of the net operating loss.

g. Accounting provisions (sec. 211 of the Act and new sec. 811 of the Code) [35]

Prior Law

Generally, under prior law, all computations entering into the determination of life insurance company taxable income were to be made under an accrual method of accounting or, to the extent permitted under regulations, under a combination of an accrual method with any other recognized method other than the cash receipts and disbursements method. Except as provided in the general rule, all such computations were to be made in a manner consistent with the manner required for purposes of the annual state-

[35] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 211; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1427-1429; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 211; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 555-557; and H. Rep. No. 98-861 (June 23, 1984), pp. 1060-1065 (Conference Report).

ment approved by the National Association of Insurance Commissioners. This provision had been interpreted to mean the State regulatory accounting procedures should control so long as they are not inconsistent with accrual accounting rules (*Commissioner v. Standard Life and Accident Insurance Company*, 433 U.S. 148 (1977)). Also, the accounting provisions included a general prohibition against deducting an item more than once in computing taxable income.[36]

When two or more related parties (within the meaning of sec. 1239) were parties to a reinsurance agreement, prior law gave the Secretary authority to allocate or recharacterize any items necessary to reflect the proper source and character of the taxable income of each related party.

Also, there was a temporary rule (adopted under TEFRA) for computing reserves on contracts under which interest was guaranteed beyond the end of the taxable year; interest payable under a contract which is computed at a rate that is in excess of the lowest rate assumed in the contract for reserve purposes and that is guaranteed beyond the end of the taxable year, is taken into account in computing reserves as if such interest were guaranteed only up to the end of the taxable year.

Finally, under prior law there were specific rules for the amortization of premium and accrual of discount on bonds and for the computation of income by life insurance companies with short taxable years.

Explanation of Provision

The Act retains the general rule in prior law that life insurance companies must use an accrual method, or a method permitted under the regulations that combines an accrual method with another recognized method. However, the Act makes it clear that accounting methods required for State regulatory purposes apply only to the extent that they are not inconsistent with Federal tax accounting rules. The change from prior law was intended to reinforce the primacy of the Federal tax rules and not to impose a new method of tax accounting on life insurance companies. Thus, for example, agents' commissions paid by direct insurers continue to be treated as sales expenses and to be deductible when paid, as has been allowed historically (even though they might be classified as acquisition expenses that should be amortized).

Although the Act continues to provide a general prohibition against any double deduction of an item, it also adopts a new rule that disallows a reserve for any item unless the gross amount of premiums and other consideration attributable to such item are required to be included in gross income. Thus, because deferred and uncollected premiums for a contract do not accrue until paid, the contractual liability related to those premiums may not be recognized until the premiums are taken into income. This provision of the Act, in effect, reverses the holding of the Supreme Court in *Commissioner v. Standard Life and Accident Insurance Co.*, 433

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[36] Actually, the prohibition is against deducting an item more than once in computing each subpart of taxable income—taxable investment income and gain or loss from operations.

U.S. 148 (1977), by statutorily requiring a matching of the reserve deduction with the related income item.

Also, with respect to the special rules for amortization of premium and accrual of discount on bonds, and short taxable years for life insurance companies, the Act made no change from prior law.

Excess interest guaranteed beyond the taxable year

The Act includes, as a permanent provision, the accounting rule adopted as a temporary provision in TEFRA for computing reserves for contracts that guarantee excess interest beyond the end of the taxable year. Under the Act, the provision is modified to reflect the new Federally prescribed reserve rules. Thus, any amount in the nature of interest that is to be paid or credited under any contract for any period at a rate in excess of the prevailing State assumed interest rate for the contract for such period, and that is guaranteed beyond the end of the taxable year, can only be taken into account in computing reserves as if it were guaranteed to the end of the taxable year. Under this rule, "amounts in the nature of interest" include both implicit and explicit guarantees for determining contractual benefits.

Thus, "amounts in the nature of interest" refers to amounts credited to policyholder reserves as assumed interest or as interest paid on such items. It includes any interest guarantee reflected implicitly or explicitly in cash surrender values or in other benefit payments in which the obligation of the insurer is not dependent upon life, health, or accident contingencies. For example, the amount of interest guaranteed cannot be artificially reduced by failing to provide for a mortality charge in computing the cash surrender value of a life insurance contract; the implicitly higher rate required to fund guaranteed cash surrender values, assuming mortality charges, must be taken into account in determining whether an amount in the nature of interest in excess of the prevailing rate has been guaranteed beyond the end of the taxable year. Also, this special reserve accounting rule would apply generally to annuity and life insurance contracts that explicitly guarantee excess interest, as well as to supplementary contracts not involving life, health, or accident contingencies for which the benefits are discounted.

On the other hand, amounts in the nature of interest do not include any assumptions or interest factors used by the company solely in setting the premium it will charge. Thus, for example, the special reserve accounting rule does not apply to annuity contracts purchased by a qualified pension plan primarily to provide periodic retirement benefits due under the plan to participants. See also the discussion of amounts in the nature of interest under the subdivision concerning policyholder dividends.

h. Definition of company's share and policyholders' share (sec. 211 of the Act and new sec. 812 of the Code) [37]

Prior Law

Under prior law, all items of investment yield (i.e., gross investment income, including tax-exempt interest and dividends received, less certain investment expenses) were allocated between the policyholders and the company. Amounts allocated to policyholders were not included in taxable investment income or gain from operations. Generally, this allocation was accomplished by means of a proration formula which, in general, compared amounts credited to policyholders to investment yield. The practical effect of the proration formula was to treat additions to reserves as funded in part out of tax-exempt income thus limiting the tax benefit a company can enjoy by the receipt of tax-exempt income.[38]

The proration formula was different depending upon whether taxable investment income or gain from operations was being computed. For purposes of computing taxable investment income, each item of investment yield was allocated between the policyholders and the company in the same proportion that the sum of the company's policy and other contract liabilities bore to its total investment yield. These policy and contract liabilities were (1) the adjusted life insurance reserves, multiplied by the adjusted reserves rate (Menge formula), (2) the mean of the pension plan reserves at the beginning and end of the taxable year, multiplied by the current earning's rate, and (3) interest paid, including interest paid on indebtedness to persons other than customers.

For purposes of computing gain from operations, each item of investment yield was allocated between the policyholders and the company in the same proportion as the required interest bore to the investment yield. Required interest was the amount of interest guaranteed to the policyholders using the interest rate assumed by the company for purposes of calculating the adjustments to its section 810(c) reserves, as well as excess interest on annuity contracts.

Explanation of Provision

The distinction between taxable investment income and gain from operations has been eliminated. However, the general concept that items of investment yield should be allocated between policyholders and the company has been retained. Under the Act, the formula used for purposes of determining the policyholders' share is based generally on the proration formula used under prior law in computing gain or loss from operations (i.e., by reference to "required interest"). Thus, amounts credited to policyholders will no longer include interest paid on indebtedness if the interest is paid to a person who is not a customer. For example, interest paid on a

[37] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 211; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1430-1431; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 211; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 557-559; and H. Rep. No. 98-861 (June 23, 1984), pp. 1065-1066 (Conference Report).

[38] "Tax-exempt income" refers generally to tax-exempt interest and deductible intercorporate dividends.

loan that is incurred to purchase a subsidiary company or other asset will not be included in determining the policyholders' share of investment yield items. On the other hand, the Act expands the items to be taken into account for the policyholders' share by including all amounts that may be paid or credited to policyholders as customers, including a portion of deductible policyholder dividends.

Specifically, under the Act, the policyholders' share of any item is 100 percent of the item reduced by the company's share of the item. The company's share is defined as the percentage obtained by dividing the company's share of net investment income by total net investment income. Net investment income is defined as 90 percent of gross investment income. Gross investment income is generally the same as under prior law, and includes tax-exempt interest. However, gross investment income does not include dividends received from a subsidiary which are eligible for the 100 percent dividends received deduction (or which would have been eligible for the 100 percent dividends received deduction if the recipient were not a foreign corporation) except to the extent such dividends are paid, directly or indirectly, out of tax-exempt income. The net investment income definition as 90 percent of gross investment income generally reflects the historical level of industry investment expenses. With the adoption of this provision, the proration computation required under present law will be simplified as compared to prior law, because of the elimination of the necessity to identify and to allocate expenses to investment rather than underwriting activities, along with the accompanying audit problems.

The company's share of net investment income is the excess of net investment income over the sum of: (1) required interest for reserves; (2) the deductible portion of any excess interest; (3) the deductible portion of any amount in the nature of interest (whether or not a policyholder dividend) credited to a policyholder or customer fund under a pension plan contract[39] for employees not yet retired or to a deferred annuity contract before the annuity starting date; and (4) a fraction (referred to as the "mini-fraction") of the deductible portion of policyholder dividends (not including the deductible portion of any amounts previously included under (1), (2) or (3), or of any premium or mortality charge adjustments associated with a contract for which excess interest was credited during the taxable year).

The amount of the required interest for reserves is determined at the prevailing State assumed interest rate. Whether a payment constitutes excess interest will be determined by the contract terms. The deductible portion of any policyholder dividend is that portion remaining after a pro rata reduction of all policyholder dividends by the differential earnings amount under section 809 (if applicable).

Finally, the fraction of the deductible portion of policyholder dividends to be included will be determined by applying a mini-fraction. The numerator of the mini-fraction is gross investment

[39] The definition of pension plan contracts is the same under the Act as under prior law except that the phrase "purchased under contracts" is eliminated since it was considered unnecessary (new sec. 818(a)).

income (including tax-exempt income), less required interest, excess interest and the amounts credited to pension plan contracts and deferred annuities (items (1), (2) and (3) described above). The denominator of the mini-fraction is gross income (including tax-exempt income), less net increases in reserve items. The application of this mini-fraction to the deductible portion of policyholder dividends recognizes that some portion of traditional policyholder dividends consists of redundant premiums (i.e., rebates of mortality and expense charges). In so recognizing this, the assumption is made that, except for those items specifically allocated to be paid out of investment income (i.e., amounts generally in the nature of interest), all other sources of income are available to pay all other expenses ratably. Thus, the company's share is the amount of net investment income that remains after paying or crediting amounts to policyholders.

Because reserve increases might be viewed as being funded proportionately out of taxable and tax-exempt income, the net increase and net decrease in reserves are computed by reducing the ending balance of the reserve items by the policyholders' share of tax-exempt interest. Similarly, a life insurance company is allowed a dividends-received deduction for intercorporate dividends from nonaffiliates only in proportion to the company's share of such dividends. 100 percent deductible dividends from affiliates are excluded from application of the proration formula, if such dividends are not themselves distributions from tax-exempt interest or from dividend income that would not be 100 percent deductible if received directly by the taxpayer.

i. Foreign tax credit (sec. 211 of the Act new sec. 818(f) of the Code) [40]

Prior Law

Under prior and present law, life insurance companies are generally subject to the same rules governing foreign income as other U.S. corporations. The United States taxes U.S. citizens and residents and U.S. corporations on their worldwide income. The United States allows U.S. taxpayers to offset the U.S. tax on their foreign income by the income taxes paid or accrued to a foreign country ("foreign tax credit").

A credit is available only for foreign taxes that are income taxes under U.S. concepts and certain taxes paid to a foreign government in lieu of an income tax otherwise imposed by that foreign government. Certain taxes on gross premiums of U.S. taxpayers engaged in the life insurance business in a foreign country have been held to be creditable "in lieu of" taxes (Rev. Rul. 74-311, 1974-2 C.B. 211; Rev. Rul. 72-84, 1972-1 C.B. 216). Income taxes paid by foreign subsidiaries of U.S. corporations are creditable when the U.S. corpora-

[40] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 211; H. Rep. No 98-432, Pt. 2 (March 5, 1984), pp. 1431-1434; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 211; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 559-562; and H. Rep. No. 98-861 (June 23, 1984), pp. 1066-1067 (Conference Report).

tion receives a dividend or a deemed dividend from the foreign subsidiary.

The foreign tax credit limitation

A fundamental premise of the foreign tax credit is that it should not offset U.S. tax on U.S. source income. Accordingly, the Code contains a limitation to ensure that the credit offsets the U.S. tax on only the taxpayer's foreign income. Under this limitation, the total pre-credit U.S. tax is multiplied by the ratio of foreign source taxable income to total worldwide taxable income to establish the amount of U.S. taxes that would be paid on the foreign income in the absence of a foreign tax credit. This amount is the upper limit on the foreign tax credit.

To calculate U.S. taxable income and foreign taxable income, which is necessary to compute the limitation, all deductions must be allocated against gross income, and apportioned against gross U.S. income or gross foreign income. Expenses that are properly allocated or apportioned to a class of U.S. (or foreign) source income reduce gross income in that category (sec. 861(b), 862(b), and 863; Reg. sec. 1.861-8). Expenses that cannot definitely be allocated to a class of gross income are generally deducted ratably from all classes of gross income.

The Internal Revenue Service has taken the position in a private letter ruling (applicable under pre-1982 law) that the numerator of the foreign tax credit limitation fraction (foreign source taxable income) is computed on a phase-by-phase basis. Thus, a company that was taxable on only its investment income (i.e., a phase-one company) would receive no foreign tax credit for premium taxes if all of its investment income were U.S. source income, even if the investment income arose from reserves held with respect to foreign business. Some taxpayers have taken the position that application of a phase-by-phase foreign tax credit limitation is improper under pre-1982 law.

Explanation of Provision

Elimination of the prior law three-phase system presupposes that gross premium income and gross investment income contribute in similar ways to total income. The Congress believed that certain deductions generally bear the same relationship to gross premium income that they bear to gross investment income. Similarly, these deductions generally bear the same relationship to gross U.S. source income that they bear to gross foreign source income. These deductions should, therefore, generally reduce U.S. source gross income and foreign source gross income ratably in calculating the foreign tax credit limitation. Similarly, reserve decreases should generally produce U.S. source gross income and foreign source gross income ratably.

Under its general rule, the Act provides that in calculating U.S. source income and foreign source income, three items will be treated under regulations as items which cannot definitely be allocated to an item or class of gross income. Thus, these items will be allocated ratably among all classes of gross income. These items are policyholder dividends (determined under new section 808(c)), reserve adjustments (under subsections (a) and (b) of new section 807), and death benefits and other amounts described in new section 805(a)(1).

The following example illustrates the application of the Act's general rule for a life insurance company that has $2,100 of gross income from all sources (including $100 of income from a net reserve decrease) and $1,800 of expenses (consisting of a death benefits deduction of $1,200 and a policyholder dividends deduction of $600):

Gross income	U.S.	Foreign source	Worldwide
Investment	$700	$300	$1,000
Premiums	600	400	1,000
Total	1,300	700	2,000
Items subject to ratable allocation:			
Income from net reserve decrease	65	35	100
Death benefits deduction	(780)	(420)	(1,200)
Policyholder dividends deduction	(390)	(210)	(600)
Worldwide net income	195	105	300

Under the Act's general rule, these items are allocated in this way regardless of the current residence of the decedents whose deaths caused the death benefit payments, the source of the premiums those decedents had paid the company in any year, the residence of the policyholders receiving or crediting dividends, or any other factor.

In some cases, the Act's general rule could be inequitable in its application to companies that can easily identify gross income to which these expenses relate. Therefore, taxpayers may elect to treat the expenses that are the subject of the general rule of the Act as properly apportioned or allocated among items of gross income in the manner and to the extent prescribed in regulations. The election will apply for all taxable years of the taxpayer to which the Act applies. It must be made on or before September 15, 1985. Once made, the election is irrevocable, except with the consent of the Commissioner.

For example, a foreign country may require life insurance companies that sell policies there to maintain reserves there. In such a case, a taxpayer could show that some deductions for reserve increases, policyholder dividends, and claims should be treated as properly apportioned or allocated among items of gross income. In addition, a taxpayer could show that some such deductions should be treated as properly apportioned or allocated to some portion of the company's investment income attributable to the company's worldwide surplus. However, a taxpayer who makes such showings will not be able to show that those deductions are properly apportioned or allocated solely to an undue amount of foreign source investment income. For example, a company whose worldwide surplus is 15 percent of reserves and that makes the election will not be able to show that any of these deductions are properly apportioned or allocated solely to foreign source investment income (from any foreign country) attributable to surplus above 15 percent above reserves that the company must maintain in a foreign country.

The election does not apply to the special life insurance company and small life insurance company deductions. All companies must treat these deductions as items which cannot definitely be allocated to an item or class of gross income.

j. Foreign life insurance companies' minimum surplus (sec. 211 of the Act and new sec. 813 of the Code) [41]

Prior Law

Foreign corporations in general

Under prior and present law, foreign corporations generally are subject to U.S. tax only on certain U.S. source income and on income that is effectively connected with a trade or business conducted in the United States. Generally, the United States imposes a flat 30-percent tax on the gross amount of U.S. source investment income (and certain other U.S. source income) paid to foreign persons when that income is not effectively connected with a U.S. trade or business. The tax on gross amounts of interest, dividends, and royalties may be reduced or eliminated under bilateral income tax treaties. See discussion of section 127 of the Act which repealed tax on certain interest income.

Taxation of foreign life insurance companies in general

Under present and prior law, a foreign corporation carrying on an insurance business within the United States, that would qualify as a life insurance company if it were a U.S. corporation, is taxable like a U.S. life insurance company on its income effectively connected with its conduct of any U.S. trade or business. The determination of whether a foreign corporation would qualify as a life insurance company considers only the income of the corporation that is effectively connected with the conduct of its business carried on in the United States.

Effectively connected income of a foreign corporation carrying on an insurance business within the United States includes all income (such as investment income attributable to required reserves) from foreign sources that is attributable to the U.S. business.[42] Such a

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[41] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 211; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1434-1436; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 211; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 562-564; and H. Rep. No. 98-861 (June 23, 1984), p. 1067 (Conference Report).

[42] Some Canadian insurance companies contended that the U.S.-Canada income tax treaty exempts from U.S. tax passive income they receive from Canadian sources, even when that passive income is effectively connected with and attributable to a U.S. business. The Court of Claims has rejected that contention (*Great-West Life Assurance Co. v. United States*, 82-1 USTC para. 9374 (1982)).

foreign corporation is taxable at the 30 percent or lower treaty rate on its U.S. source investment income that is not effectively connected with a U.S. trade or business.

A foreign life insurance company that is engaged in a U.S. trade or business is taxable on U.S. source underwriting income but not on foreign source underwriting income (unless that foreign source underwriting income is effectively connected with a U.S. trade or business).

Minimum surplus requirement

Under prior law, a special rule altered the U.S. tax on foreign life insurance companies doing business in the United States if they held a relatively small surplus attributable to the U.S. business in the United States. This rule applied when the surplus of a foreign life insurance company held in the United States was less than a specified minimum. That minimum amount was the foreign company's total insurance liabilities on U.S. business multiplied by the ratio of the average surplus of domestic corporations to their total liabilities. The Secretary of the Treasury determined this ratio each year.

If the foreign insurance company's surplus held in the United States was less than this minimum amount, then certain deductions of the company decreased. The policy and other contract liability requirements, and the required interest for computing gain from operations, were reduced by the deficiency multiplied by the current earnings rate. An increase in tax caused by this adjustment of surplus could have been offset by a reduction in the flat-rate tax on investment income not effectively connected with the U.S. business. The reason for reduction in the flat-rate tax was that part of that investment income, in effect, could have been income subject to tax under the minimum surplus adjustment.

For the purpose of this minimum surplus requirement, regulations provide for a separate computation of surplus with respect to segregated asset accounts of foreign life insurance companies. For such accounts, in general, the required surplus was 1 percent of liabilities (Treas. reg. sec. 1.819-2(b)(4)).

Explanation of Provision

The Act generally retains the Secretary's ratio adjustment, with modifications. Except for the specific modifications to conform it to the new general structure for taxing life insurance companies, the minimum surplus provision was intended to operate on the same requirements as under prior law. A foreign company taxable as a life insurance company must compare its surplus held in the United States to a required surplus computed under the new statute. If the required surplus exceeds the actual surplus, the company must increase its income by the product of that excess and its current investment yield.[43]

[43] Some have suggested that this imputation of income (rather than a reduction of a deduction, as in prior law) may exceed the taxing power granted under the Sixteenth Amendment. Were this or any other provision of this title of the Act found to be unconstitutional, the Congress intended sec. 7852(a) to operate to preserve the remainder of the Act's provisions.

The Act requires the calculation of required surplus in a manner similar to the calculation of the "minimum figure" under prior law. The Secretary of the Treasury is to calculate the percentage used in the taxpayer's calculation in a manner similar to the manner of prior law. Taxpayers calculate current investment yield by dividing net investment income on assets held in the United States by the mean of assets held in the United States. For this purpose only, the taxpayer is to use amounts required to be set forth on the NAIC annual statement.

The Act also provides definitions of surplus held in the United States and total insurance liabilities. Surplus held in the United States is the excess of assets held in the United States over the total insurance liabilities on U.S. business; this computation was intended generally to be the same as under prior law. Thus, for the purpose of valuing assets in the determination of surplus, the Congress intended that the Secretary promulgate regulations that indicate that taxpayers are not to value assets under the method used in the NAIC statement, but are to use a method similar to the method prescribed under prior law. Likewise, total insurance liabilities means the sum of total reserves (generally as defined in new sec. 816(c) but excluding deficiency reserves as under prior law) plus, to the extent not included in total reserves, the items referred to in paragraphs (3), (4), (5), and (6) of new section 807(c). Also, the Congress intended that the Secretary adopt regulations governing required surplus attributable to segregated asset accounts similar to the regulations in effect under prior law.

As under prior law, an increase in tax caused by this adjustment of surplus may be offset by a reduction in the flat-rate tax on investment income not effectively connected with the U.S. business.

The Act provides a new rule for foreign mutual life insurance companies that reflects the equity base concept of the new statute. Each such company that is taxable as a life insurance company in the United States is to increase its equity base by the excess (if any) of its required surplus over its actual surplus.

k. Contiguous country branches of U.S. life insurance companies (sec. 211 of the Act and new sec. 814 of the Code) [44]

Prior Law

Under present and prior law, U.S. corporations are taxable on worldwide income, including foreign income (although the foreign tax credit may offset U.S. tax on foreign income). In general, foreign corporations (even those wholly owned by U.S. persons) are not subject to U.S. tax on foreign income. U.S. shareholders of a foreign corporation generally are exempt from U.S. tax on the earnings of the foreign corporation until it pays them a dividend (unless it engages in tax-haven or tax avoidance activity). Foreign

[44] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 211; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1436-1438; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 211; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 564-565; and H. Rep. No. 98-861 (June 23, 1984), p. 1068 (Conference Report).

branch operations of U.S. taxpayers generally are subject to tax currently.

Branches of mutual companies generally derive their income from the issuance of policies on local risks and from investment income from reserves on local risks. Under the principle of mutuality, this income inures solely to the benefit of local policyholders. Thus, a foreign branch of a mutual life insurance company is similar to a foreign corporation owned by non-U.S. persons. Congress, therefore, provided under prior law that a U.S. mutual life insurance company may generally elect to exempt the income of its branches that operate in Canada or Mexico (sec. 819A) [45] so long as the foreign branch does not repatriate its income to the United States. Repatriation of contiguous country branch income resulted in an increase in life insurance company taxable income. In this respect, the treatment of contiguous country branches corresponded generally to the treatment of foreign subsidiaries of U.S. parent companies.

In general, a transfer of property by a U.S. person to a foreign corporation can qualify for nonrecognition treatment only if the exchange does not have as one of its principal purposes the avoidance of U.S. tax (sec. 367). A special rule applies (1) to elections by U.S. mutual life companies to use the special contiguous country branch rule and (2) to certain incorporations by U.S. stock life companies of contiguous country subsidiaries. In general, in each case, there is a deemed sale of the invested assets and tangible property subject to the election or transferred in the incorporation. The gain that the company recognizes is the excess of the fair market value of those invested assets and that tangible property over their aggregate adjusted basis. The company does not recognize gain attributable to goodwill, since it is an intangible asset.

Explanation of Provision

The Act retains the contiguous country branch rule of prior law, with technical modifications. Thus, repatriation of contiguous country branch income results in an increase in income. As under prior law, payments, transfers, reimbursements, credits, or allowances which are made from a separate contiguous country branch account to one or more accounts of the domestic company as reimbursements for costs (e.g., home office services) incurred for or with respect to the insurance (including reinsurance) of risks accounted for in the separate branch account are taken into account by the domestic company in the same manner as if the payment, transfer, reimbursement, credit, or allowance were received from a separate person. For this purpose the rules in the Internal Revenue Code (sec. 482) dealing with reimbursement of costs between related parties continue to apply and the domestic company must establish procedures for billing the branch at arm's length. As under prior law, reimbursements under this provision are not treated as repatriation of income.

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[45] For the legislative history of these life insurance company provisions, see: H.R. Rep. No. 94-658, 94th Cong., 1st Sess. 248-252 (1976), and S. Rep. No. 94-938, 94th Cong., 2d Sess. 271-275 (1976).

If amounts are directly or indirectly transferred or credited from a contiguous country branch account to one or more other accounts of the domestic company, they are to be added to the income of the domestic company except to the extent the transfers are reimbursements for home office services. The amount added to income cannot exceed the amount by which the aggregate decrease in the tentative LICTI, for the taxable year and for all prior taxable years resulting solely from the application of these exclusion provisions with respect to the contiguous country branch, exceeds the amount of additions to the tentative LICTI with respect to that branch which were treated as a repatriation of income for all prior taxable years. For this purpose, in the case of a prior taxable year beginning before January 1, 1983, "tentative LICTI" means life insurance company taxable income computed under the law in effect during the earlier taxable year.

Section 217(a) of the Act provides that an election under section 819A of prior law will be treated as an election under new section 814, and that references to new section 814 will be treated as references to the corresponding provision of section 819A of prior law.

l. Rules relating to capital gains and losses (sec. 211 of the Act and new secs. 818(b) and (c) of the Code) [46]

Prior Law

With respect to property used in a trade or business and held for more than 12 months, present and prior law provide, in general, that if the gains from the sale or exchange of such property exceed the losses, then each gain and loss is treated as though it was from the sale or exchange of a long-term capital asset. If the losses exceed the gains, then each gain or loss is considered as not being from the sale or exchange of a capital asset, with the result that ordinary gain or loss is realized.

In the case of life insurance companies, a special rule modified the general rule by limiting the term "property used in the trade or business" to include only property used in carrying on an insurance business. Further, for purposes of section 1221(2) (excluding certain property from the term "capital assets"), the reference to property used in trade or business was treated as including only property used in carrying on an insurance business.

In both cases, the term "property used in carrying on an insurance business" meant only those assets used in the operation of the insurance trade or business.

Under prior law, the amount of gain that was recognized on the sale or other disposition of certain property acquired before December 31, 1958 was limited. In the case of property acquired after December 31, 1958, having a substituted basis (within the meaning of sec. 1016(b)), the limitation on the gain recognized applied if the property or properties were held only by life insurance companies

[46] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 211; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1438-1439; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 211; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 565-566; and H. Rep. No. 98-861 (June 23, 1984), pp. 1068-1069 (Conference Report).

during the relevant periods. The term "property" did not include insurance and annuity contracts (and contracts supplementary thereto) and property described in section 1221 relating to stock in trade or inventory-type property.

Explanation of Provision

The Act continues the prior-law treatment relating to capital gains and losses and gains and losses on property used in the trade or business for life insurance companies.

Under the prior-law provisions, there are regulations for assumption reinsurance transactions which were generally treated as a sale of a block of business. The Act continues the prior distinction between indemnity and assumption reinsurance arrangements. Likewise, the Congress intended that the regulatory position of Treasury with respect to assumption reinsurance transactions would continue.

m. Technical and conforming amendments (sec. 211(b) of the Act)

Section 211(b) of the Act contains 27 technical changes to the provisions of the Internal Revenue Code of 1954 outside of Part I of subchapter L. These amendments conform the existing provisions of the 1954 Code to the new single phase tax system adopted for life insurance companies under the Act.

n. Certain reinsurance agreements (sec. 212 of the Act and new sec. 845 of the Code) [47]

Prior Law

In general, under both prior and present law, the tax law recognizes the economic consequences of reinsurance transactions between life insurance companies. The Code distinguishes between indemnity reinsurance (or reinsurance ceded) and assumption reinsurance. The first is an arrangement whereby the ceding company remains solely liable to the policyholder, whether all or only a portion of the risk has been transferred to the reinsurer. The second is an arrangement whereby another person (the reinsurer) becomes solely liable to the policyholders on the contracts transferred by the ceding company. Whereas an indemnity reinsurance contract describes a continuing insurance relationship between the ceding company and the reinsurer, an assumption reinsurance contract is considered a sale of a block of business.

Under the 1959 Act, prior to TEFRA, there was a special rule which allowed the ceding company and the reinsurer to report a modified coinsurance transaction for tax purposes as if the assets relating to the risks reinsured were transferred to the reinsurer, as if the premium income for the reinsured policies and the investment income on the assets were received directly by the reinsurer,

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[47] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 201 (new sec. 811(d)) Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1427-1429; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 211 (new sec. 811(d)); S. Prt. 98-169, Vol. I (April 2, 1984), pp. 555-557; and H. Rep. No. 98-861 (June 23, 1984), pp. 1060-1065 (Conference Report).

and also as if reserves to reflect liability for future claims were maintained by the reinsurer. However, no transfer of assets or reserves actually occurred. This special rule was repealed by TEFRA in 1982.

Also, under TEFRA, Treasury was granted authority to allocate or recharacterize items related to a reinsurance contract between related persons (as defined in sec. 1239(b)) if it determined that such action was necessary to reflect the proper source and character of taxable income of the parties (including any item used in determining taxable investment income and gain from operations). The scope of authority granted under the provision was broader than that granted under the law generally in section 482. This provision was applicable to reinsurance arrangements involving an affiliated casualty insurance company and also to a contract even if one of the related parties was not a domestic life insurance company.

Explanation of Provision

In the case of reinsurance agreements, the Act expands the authority of Treasury to examine and make adjustments with respect to reinsurance agreements.

First, as under prior law, in the case of a reinsurance agreement between two or more related persons, the Treasury can allocate among the parties or recharacterize income, deductions, assets, reserves, credits, and any other items related to the reinsurance agreement or make any other adjustment, in order to reflect the proper source and character of the items for each party. Under the Act, however, related parties are defined as they are in section 482. Thus, two or more parties are related if they are organizations or entities, whether or not incorporated or affiliated, owned or controlled directly or indirectly by the same interests. Also, Treasury can use its recharacterization authority for a reinsurance agreement between unrelated parties where one of the parties to the agreement (with respect to any contract covered by the agreement), in effect, is an agent of another party to such agreement or is a conduit between related persons. Thus, although one party may not have de facto control over the business of the other party (as required by sec. 482), it may have unilateral control over the profit levels for both parties with respect to specific lines of business covered by a reinsurance agreement, which can be used to distort the income of the parties.

The Act also makes it clear that the allocation and recharacterization authority can be used with respect to related persons when one party to a reinsurance transaction acts as a conduit between the related persons. Whether a party is an agent of, or conduit between, other parties must be determined in light of all the facts and circumstances. An example of a fact that would tend to establish that an agency relationship existed is control on the part of the reinsurer over the amount of policyholder dividends that are paid by the reinsured. The Secretary also may make any other adjustment or recharacterization for one or both parties if the transaction has unrelated parties acting as agents or conduits for another. This authority is generally similar to that provided under section 482 for the Secretary to make correlative adjustments between related parties, except that the authority extends to a broader class of items and may be exercised whenever it is necessary to reflect the proper character and source of the item.

Second, if the Secretary determines that a reinsurance contract between insurance companies, whether related or unrelated, has a significant tax avoidance effect on any party to the contract, the Secretary may make an adjustment to one or both parties to eliminate the tax avoidance effect, including treating the contract as terminated on December 31 of each year and reinstated on January 1 of the next year. This second reinsurance rule differs from the general related party allocation and recharacterization authority in that before making adjustments under this second rule the Secretary must determine that there is a "significant tax avoidance effect" to the reinsurance agreement as opposed to meeting the lower standard of "necessary to reflect the proper source and character of the taxable income." Any transaction which would be within the scope of the second rule but for the fact that the parties are not related, generally will be within the scope of the related party reinsurance rule. On the other hand, a transaction which would not give rise to adjustments if entered into by unrelated parties might result in adjustments as among related parties.

In general, whether a reinsurance contract has a tax avoidance effect with respect to any party should be determined by reference to the effect (with respect to one or both parties) in the current year or any other year, after taking into account the time value of money. A tax avoidance effect may arise, for example, when the reinsurance contract artificially reduces a company's equity, changes the source or character of any item, defers taxation of income items, eliminates the "SRLY taint" of a previous net operating loss, artificially transfers tax benefits between taxpayers in different tax brackets, or effectively extends a carryover period. A tax avoidance effect is significant if the transaction is designed so that the tax benefits enjoyed by one or both parties to the contract are disproportionate to the risk transferred between the parties. There is no significant tax avoidance effect for a reinsurer, however, merely because a tax reduction arises from a loss on the reinsurance contract for a particular year, if the loss experienced was no greater than if the reinsurer had written the allocable portion of the reinsured business directly.

In making the determination whether a reinsurance agreement between unrelated parties has a significant tax avoidance effect with respect to one or both of the parties, the Secretary should examine the economic substance of the transaction, taking into account factors such as those described below. These factors may suggest that a significant tax avoidance effect exists for either or both of the parties, but none alone will be determinative.

First, the duration or age of the business reinsured should be taken into account because it bears directly on the issue of whether significant economic risk is transferred between the parties. For example, the coinsurance of new contracts may carry a risk of lapse as well as the mortality risk of the underlying contracts; thus, there may be a significant economic risk that the reinsurer will not realize its share of the potential profits of the underlying contracts.

On the other hand, the reinsurance of an old block of business, for which the risk of lapse is minimal, may not result in a significant economic risk being transferred between the parties in proportion to the tax benefits enjoyed.

Second, the character of the business reinsured should be taken into account in determining whether the tax benefits of any party are disproportionate to the risk transferred. For example, coinsurance of yearly renewable term life insurance will generally not have significant tax avoidance effect for the parties to the transaction because it does not involve the transfer of long-term reserves as under the coinsurance of ordinary life insurance.

Third, the structure for determining the potential profits of each of the parties and any experience rating should be considered by Treasury. If the experience rating formula results in the reinsurer receiving only an annual risk premium, plus a fixed fee, the transaction might be viewed as economically equivalent to yearly renewable term reinsurance combined with a financing arrangement between the ceding company and the reinsurer. However, if the experience rating formula results in the reinsurer assuming a risk of loss beyond the annual mortality risk, as well as enjoying a share of the profits commensurate with its loss exposure, such a factor may indicate that tax benefits arising from the assumption of reserve liabilities by the reinsurer are not disproportionate to the risk transferred between the parties.

Fourth, the duration of the reinsurance agreement between the parties should be considered. The fact that there has been a longstanding agreement for automatic reinsurance of certain types of policies would tend to indicate that there is no significant tax avoidance effect when a coincidental tax benefit is enjoyed by a ceding company because income arising from the reinsurance transaction offsets an expiring loss carryover. On the other hand, even a longstanding agreement may be ignored if the experience rating formula in effect allows the parties to tailor income, expense, and profit allocation on an individual contract basis.

Fifth, the parties' rights to terminate the reinsurance agreement and the consequences of a termination should also be taken into account. For example, a contract may contain payback provisions to protect a reinsurer against termination of the reinsurance agreement after a large upfront ceding commission has been paid, but before the reinsurer has been able to enjoy the future profit stream. Such a provision may be a reasonable business practice and should not automatically be viewed as creating a tax avoidance effect. On the other hand, a payback provision which allows a reinsurer to recover all its losses in any case, through adjustments in future premiums or specific termination provisions, would indicate that the transaction is merely a financing arrangement.

Sixth, the relative tax positions of the parties is a factor that should be considered. The essential tax benefit or avoidance effect from a reinsurance transaction arises because income and deductions will have differing economic value depending on the tax bracket of the insurance company. For example, under the new life insurance provisions, bracket shifting is possible between small and large companies, as well as between profit and loss companies or between life and nonlife insurance companies.

Seventh, the general financial situations of the parties may be relevant. For example, surplus relief insurance for an otherwise insolvent insurance company tends to indicate that the transaction may not have a significant tax avoidance effect.

The operative standards for both of the reinsurance adjustment provisions are objective tests of (1) whether adjustments are necessary to reflect the proper source and character of taxable income, or (2) whether the transaction has a significant tax avoidance effect. The motivations of the parties is wholly irrelevant in making this determination. The fact that a transaction has a business purpose or was not entered into with tax avoidance or evasion as a principal purpose or is entered into at arm's length will not foreclose Treasury from examining a reinsurance transaction under either the first or second reinsurance adjustment provisions.

In the case of any reinsurance transaction between unrelated parties, the determination of a significant tax avoidance effect for one party to a reinsurance contract, for example, together with any adjustments deemed proper by the Secretary (including deemed termination of the contract), will not require that any correlative adjustments be made to the other party to the contract. Similarly, correlative adjustments are not required as between unrelated parties (such as in the agent or conduit situation) under the adjustment and recharacterization authority of the first provision. Also, the adjustment authority under either reinsurance provision can be exercised with respect to any transaction characterized as reinsurance or insurance by the parties. The exercise of such authority will not preclude the Treasury from also questioning whether the transaction constitutes insurance or reinsurance for other purposes.

Taking into account the types of factors described above, and until Treasury regulations can be issued, there are certain kinds of reinsurance transactions which generally will not require Treasury to exercise its adjustment authority. First, yearly renewable term reinsurance will not require adjustments for the parties, to the extent it requires only the payment of a premium for the annual risk and no sharing of expenses. Second, coinsurance of annual renewable term life insurance will generally not require adjustments because it requires the transfer of an annual risk premium and a sharing of expenses, but does not involve the transfer of long-term reserves. Third, a coinsurance contract covering new business of the ceding company and which allocates expenses and income items between the ceding company and the reinsurer in the same proportion as the allocation of the risk reinsured generally will not require adjustment by Treasury. The same will be true with respect to the reinsurer for the coinsurance contract entered into to cover existing business, if the initial ceding commission is reasonable in reflecting the proper allocable share of past expenses of the ceding company and any premium that might be paid by the reinsurer to the ceding company that reflects anticipated profitability of the reinsured business. The Congress anticipated that the Treasury will provide more guidance in regulations under these provisions. To the extent that future regulations in these areas are inconsistent with the above-described specific examples of situations that will not require Treasury to exercise its adjustment authority, the Congress intended that those regulations have effect only prospectively.

The provision for related party reinsurance is effective with respect to any risks reinsured on or after September 27, 1983. The provision for unrelated party reinsurance is effective with respect to any risks reinsured after December 31, 1984. For these purposes, a risk is not considered reinsured prior to the time it arises under the contracts covered by the reinsurance agreement. The reinsurance adjustment provisions were specifically placed in part IV of subchapter L to clarify that both the reinsurance provisions will apply to any reinsurance transactions between any insurance companies taxable under subchapter L.

o. Effective date and transitional rules (secs. 215, 216, 217, 218, and 219 of the Act) [48]

Effective Date

Generally, the life insurance company taxation provisions apply to taxable years beginning after December 31, 1983.

Transitional Rules

Reserves computed on a new basis

As of the beginning of the first taxable year after December 31, 1983, the reserve for any contract is to be recomputed as if the amendments made in this Act had applied to the contract when it was issued. This provision applies to reserves held by any company taxable under subchapter L of the Code (relating to the taxation of insurance companies). To implement this recomputation, a property and casualty insurance company (taxable under parts 2 and 3 of subchapter L), in making its unearned premium computation, should determine the unearned premiums on outstanding business at the end of the preceding taxable year as though the new reserve provisions (new sec. 807) were applicable to such reserves in the preceding year. As noted under the discussion of the reserve rules, the date of issue of a contract is generally the date on the policy; with respect to group contracts, the date of issue is the date as of which the master plan is issued (or with respect to a benefit guaranteed to a participant after such date, the date as of which the benefit is guaranteed). However, for purposes of recomputing reserves as of January 1, 1984, if the issuance date of any group contract cannot be determined, the issuance date shall be determined on the basis prescribed by Treasury. It was intended that Treasury develop some method for approximating the issuance date that generally reflects the pattern of growth in the type of group business.

The Act also provides a special rule (sec. 216(c) of the Act) under which certain qualified life insurance companies can elect not to recompute reserves for existing contracts as of January 1, 1984, but

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[48] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, secs. 215, 216, and 217; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1439-1441; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, secs. 215, 216, 217, and 218; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 566-570; and H. Rep. No. 98-861 (June 23, 1984), pp. 1069-1074 (Conference Report).

to use their statutory reserves for all such contracts. In so using statutory reserves for tax reserves, a company elects to forgo the "fresh start" (described below) with respect to the difference between statutory reserves and the Federally prescribed reserves; there will still be a fresh start with respect to the difference between statutory reserves and prior-law tax reserves attributable to a prior-law 818(c) election. For these purposes, a qualified life insurance company is any life insurance company which, as of December 31, 1983, had assets of less than $100 million (determined on a controlled group aggregate basis as for the small life insurance company deduction). Also, as a transitional rule, any company that makes the above described election and that has tentative LICTI for its first taxable year after 1984 of $3 million or less may further elect to have the reserve for any contract issued on or after 1983 and before January 1, 1989, be equal to the statutory reserve for the contract, recomputed for tax purposes with an adjustment similar to the geometric Menge formula adopted under TEFRA (sec. 805(c)(1) of prior law as in effect for 1982 and 1983). The above described elections must be made at the time and in the manner prescribed by Treasury and, once made, are irrevocable.

Fresh start

In general, any change in accounting (e.g., in computing the policyholder dividends deduction) or any change in the method of computing reserves which is required by the provisions in the Act is not to be treated as a change in the method of accounting or in the method of computing reserves, and does not give rise to income or loss. This "fresh start" provision applies solely to changes made between any company's first taxable year beginning after December 31, 1983, and the preceding taxable year. For purposes of the fresh start provision, a change is considered to be required by the Act even though a company is eligible to elect to not make the change and forgo the fresh start benefit (for example, under sections 216(c) or 217(n) of the Act).

As a practical matter, the fresh start provision relieves insurance companies of the obligation to recognize income from any decrease in reserves caused by the recomputation of tax reserves as of January 1, 1984. Viewed in another way, the recomputation of the tax reserves to a lower level allows companies to deduct the same reserve amounts a second time without recapturing the previous tax benefits as income. In keeping with this fresh start approach, any adjustments recognizing income that are attributable to decreases in reserves for a change in basis of computing reserves in a taxable year beginning before 1984 are not taken into account after 1983. Likewise, any adjustments spreading deductions for increases in reserves for a change in basis of computing reserves can continue to be taken into account only to the extent the adjustment amounts remaining after 1983 exceed the amount of the fresh start adjustment.

Generally, the fresh start adjustment for any contract is the excess (if any) of the tax reserve as of the close of the 1983 tax year over the recomputed reserve as of the beginning of the 1984 tax year. This treatment of adjustments attributable to changes in basis of computing reserves (which under prior law was traditionally called "reserve weakening" or "reserve strengthening") effectively eliminates any benefit that might be gained by traditional reserve strengthening reported for Federal income purposes after September 27, 1983, for a taxable year ending before 1984. Note that under prior law, as under the Act, any benefit from an increase in reserves due to a change in basis of computing reserves (i.e., traditional reserve strengthening) is spread over 10 years beginning with the first year after the year of change. Thus, any tax benefit to be derived from any traditional reserve strengthening in 1983 would not have been enjoyed by a company until 1984 and is denied under the above described provision.

In relation to the denial of continued adjustments for increases in reserves attributable to a change in basis in a taxable year before 1984, the Act provides a conforming rule that no premium is included in income to the extent the premium is directly related to an increase in a reserve for which continued adjustments have been denied. This special rule addresses a situation brought about by the Supreme Court decision in *Standard Life* under which certain taxpayers were required to set up reserves and recognize premium income for liabilities for which actual gross premiums were deferred and uncollected.

Denial of "fresh start" in certain cases

An effective date of January 1, 1984, and the intention to grant insurance companies a fresh start with respect to their reserves revalued under new statutory provisions as part of the plan to reform the life insurance provisions, was announced on September 27, 1983, the date of mark-up of the proposed bill by the Select Revenues Subcommittee of the House Ways and Means Committee. Because it was recognized that taxpayers might engage in certain business activities between September 27, 1983, and the end of the year to maximize tax benefits caused by a change in the life insurance provisions, the House bill denied the fresh start with respect to reserves affected by such business activities. The Senate adopted a bill with the same effective date and fresh start provisions, but addressed the problem of tax manipulation by business activities between September 27, 1983, and the end of the year either by not giving tax effect to certain transactions during that period until 1984 or by not giving tax effect to certain tax benefits arising from actions related to that period. The final Act continued to reflect the Congress' concern over tax manipulation by activities between September 27, 1983, and 1984 and combined approaches of both the House and Senate.

First, the fresh start provision does not apply to any reserve transferred pursuant to a reinsurance agreement entered into, or a modification of a reinsurance agreement made after, September 27, 1983, and before January 1, 1984. The "reserve transferred" refers to the reserve on the books of the reinsured, for tax purposes, as a result of the reinsurance transaction. Thus, if the reinsurer had a prior-law 818(c) election, the fresh start does not apply to either the 818(c) amount or the difference between the statutory and Federally prescribed reserves resulting from a reinsurance transaction within the proscribed period (this would be the case, whether or not the ceding company had an 818(c) election). Under this provision, if the entering into or modification made occurred during the proscribed time period because of a binding agreement between the parties or written notice on an earlier date, the date of the earlier agreement controls whether there is a denial of the fresh start benefits. Relevant factors to consider in determining whether there was a binding agreement before September 28, 1983, would be partial performance before September 28, 1983, under the subsequent reinsurance agreement; internal memoranda recognizing the reinsurance agreement; board of director resolutions or other board actions before September 28, 1983, directing that the reinsurance agreement be entered into or evidencing their intent to do so; existence of a draft of the reinsurance agreement or other written documents before September 28, 1983, evidencing agreement on substantially all material items relating to the reinsurance transaction; submission to or approval by the State insurance department of the draft reinsurance agreement; and incurrence of substantially all the costs associated with the reinsurance transaction before September 28, 1983.

Second, the fresh start benefits do not apply to any reserve strengthening (i.e. the excess of the strengthened reserves over the reserves prior to the strengthening) reported for Federal income tax purposes after September 27, 1983, for a taxable year ending before January 1, 1984. For these purposes, the phrase "any reserve strengthening" is intended to refer to the computation of reserves on contracts issued in 1983 at an interest rate that is lower than the rate normally assumed in computing reserves for similar contracts, or to the strengthening of reserves for tax purposes generally, on existing business. Specifically, the denial of fresh start benefits for reserve strengthening does not apply to the computation of reserves on any contract issued if the computation employs the reserve practice used for purposes of the most recent annual statement filed before September 27, 1983, for the type of contract with respect to which the reserves are set up. The Act does not treat an election to revalue reserves under prior-law section 818(c) on a return filed after September 27, 1983, as general reserve strengthening for tax purposes under this provision; rather the Act prohibits such elections from taking effect (see discussion below).

Third, the Act provides specific rules for how the reserve decreases arising from the recomputation provision will be taken into account for situations in which there is a denial of fresh start benefits. Generally, the recomputation of reserves prescribed by the Act constitutes a change in basis for computing reserves that requires that the difference between 1984 year-end reserves computed on the new basis and 1984 year-end reserves computed as under the 1959 Act must be taken into account over 10 years, beginning in 1985 (see new sec. 807(f)). The Act provides a special rule for tax reserve amounts attributable to the section 818(c) revaluation (see sec. 216(b)(3)(B) and (C)) for which a fresh start is denied and requires that such amount be taken into account in the first taxable year beginning after December 31, 1983; a 10-year spread is denied for reserve amounts if no 10-year spread would have been applicable to such amounts under the 1959 Act.

Fourth, any amount included in income as a decrease in reserves, and any income attributable to expenses transferred in connection with any proscribed transfer of reserves, will not be taken into account for purposes of determining the amount of the special and small life insurance company deductions (sec. 216(b)(3)(D) of the Act). Because the tax benefit for the increase in reserves and expense deductions occurred in 1983, when life insurance companies were taxed at a 46 percent rate, the income later attributable thereto, without the special and small company deductions, is taxed at a 46 percent rate.

Fifth, the Act denies the deductions for nonparticipating contracts and accident and health insurance and group life insurance contracts, if those deductions arose from the entering into or the modification of a reinsurance agreement during the proscribed period. Rather than denying such deductions by treating the proscribed reinsurance activities as occurring in the 1984 tax year, the Act denies the deductions for the 1983 tax year.

Elections under section 818(c) after September 27, 1983, not to take effect

In general, any election after September 27, 1983, under prior-law section 818(c) is not given effect under the Act. However, a proper election under section 818(c) of prior law will be given effect and the resulting reserves will be eligible for fresh start benefits if more than 95 percent of the section 818(c) amount arises from risks under life insurance contracts issued by the taxpayer under a plan of insurance first filed after March 1, 1982, and before September 28, 1983.

Allocation of the "fresh start" in certain cases

The Act provides the "fresh start" benefit shall be allocated between the reinsured (or ceding company) and the reinsurer with respect to reserves subject to an indemnity reinsurance agreement entered into during 1982 or 1983 if the reserves on such contracts are recaptured after 1983. Generally, the "fresh start" benefit is allocated by income recognition or deductions for recaptured reserves upon termination of the reinsurance agreement, making the amounts under the allocation reflect the post-1983 duration of the agreement between the parties. For this purpose, a lapse of a policy covered by a reinsurance agreement is not considered a termination. Also, the voluntary termination of a reinsurance agreement, by either party, followed by entering into a substantially similar agreement between the parties is not considered a termination. If the amount of the reserves with respect to the recaptured contracts (computed at the date of recapture) that the reinsurer would have taken into account under prior law exceeds the amount of the reserves with respect to the recaptured contracts (computed at the date of recapture) taken into account by the reinsurer under the Act, the excess is to be taken into account by the reinsurer, in computing life insurance company taxable income, over a 10-year period commencing with the taxable year of termination. However, the excess taken into account by the reinsurer cannot exceed the amount of such excess if computed on January 1, 1984. The amount of the excess must also be reduced by any portion of such excess for which there was a required 10-year spread because of a denial of the fresh start provision. The same amount of excess, if any, shall be taken into account by the ceding company over a 10-year period commencing with the taxable year of recapture. If the reinsurer does not take any amount into account in computing life insurance company taxable income (for example, if the reinsurer is not a U.S. taxpayer) no amount can be taken into account by the ceding company. For these purposes, the term "reinsurer" refers to the taxpayer that held reserves with respect to the recaptured contracts as of the end of the taxable year preceding the 1984 taxable year; and the term "reinsured" or ceding company refers to the taxpayer to which the reserves are ultimately transferred upon termination.

This special allocation rule applies if: (1) insurance and annuity contracts in force on December 31, 1983, are subject to a conventional coinsurance agreement entered into after December 31, 1981 and before January 1, 1984; and (2) such contracts are recaptured by the ceding company in any taxable year beginning after December 31, 1983.

Special Rules

Installment contracts

If, prior to January 1, 1984, an election is made to treat income from an installment obligation as investment income, any income from such obligation shall be treated as attributable to a noninsurance business. Noninsurance business is defined as any trade or business which is not an insurance business; however, any noninsurance business that traditionally has been carried on by life insurance companies for investment purposes shall be treated as an insurance business. Section 217(b) of the Act.

Determination of tentative LICTI in cases of acquisitions in 1980, 1981, 1982, and 1983

In certain specific cases that involve the acquisition of one or more insurance companies, a transitional rule (sec. 217(c) of the Act) is provided which permits increases in tentative LICTI. In order to qualify, a corporation must be domiciled or have its principal place of business in Alabama, Arkansas, Oklahoma, or Texas and had to acquire the assets of one or more insurance companies after 1979 and before April 1, 1983. In addition, the bases of the acquired assets in the hands of the acquiring corporation had to have been determined under sec. 334(b)(2) (as in effect prior to TEFRA) (relating to the basis of property received in complete liquidation of a subsidiary) or the corporation had to have made an election under sec. 338 (relating to the treatment of stock purchases as asset acquisitions). The date of the acquisition of assets for cases involving a section 338 election is the "acquisition date," as defined in section 338(h)(2); for cases involving section 334(b)(2) (as in effect prior to TEFRA), the date of the acquisition of the assets is the date of the liquidation of the acquired corporation. If these tests are met, then the tentative LICTI of the corporation holding the assets for taxable years after December 31, 1983, is increased by the deduction allowable for the amortization of the cost of insurance contracts acquired in the acquisition and for any portion of any operations loss deduction attributable to such amortization.

The effect of the increase in tentative LICTI is to increase the base for the 60 percent (of the first $3 million) small life insurance company deduction and the 20 percent special life insurance company deduction. As a practical matter, this allows the amortization deductions to be taken at a 46 percent tax rate, rather than the lower effective rate brought about by the special and small company deductions.

Treatment of certain debt financed acquisitions

Under a special rule (sec. 217(k)), the amount of tentative LICTI on which the special and small life insurance company deductions are based for one company will not include income or losses from ownership of stock in another corporation through a partnership when the stock was acquired in a debt-financed transaction on January 14, 1981.

Treatment of certain guaranteed interest contracts

The Act provides another special rule (sec. 217(l)) for one company with certain losses on guaranteed interest contracts used in pension business by allowing a deduction of those losses after the computation of the special and small life insurance company deductions. These losses result from the company's guarantee of a long-term interest rate and intention to meet the obligation by matching the interest rate guarantee with investments in discounted bonds. It relied on both the current income of the bond and the amount of the discount to be realized at capital gain rates. To the extent the guaranteed interest rate exceeds the current income of the discounted bond, the company is allowed a deduction at a full 46 percent tax rate in order to maintain the economics of the transactions with respect to existing guarantees. The amount of tax benefit that can be enjoyed by the company because of this rule is limited to $4.5 million in 1984, $4.5 million in 1985, $3.0 million in 1986, $2.0 million in 1987, and zero for 1988 and thereafter.

Treatment of a stock-mutual company

Any company that has been operating for a ten-year period ending on December 31, 1983, as a mutual life insurance company with shareholders, as authorized by the law of the State in which it is domiciled, is treated as a stock life insurance company. Section 217(e) of the Act.

Waiver of Estimated Tax Penalty

Any penalty for underpayment of estimated tax by an insurance company, for any period before the date of enactment is waived to the extent the underpayment is due to changes from prior-law tax provisions that are made retroactive by the effective date of the Act. (Section 218 of the Act.) Despite the provision's title reference to 1984, this provision was intended to apply with respect to any period affected by the Act, whether in 1983 or 1984.

3. Taxation of Life Insurance Products

a. Definition of a life insurance contract (sec. 221 of the Act and new sec. 7702 of the Code) [49]

Prior Law

Generally, there was no statutory definition of life insurance under prior law. A life insurance contract was defined generally in section 1035 (relating to tax-free exchanges) as a contract with a life insurance company which depended in part on the life expectancy of the insured and which was not ordinarily payable in full during the life of the insured.

Under prior and present law, income earned on the cash surrender value of a contract is not taxed currently to the policyholder, but it is taxed upon termination of the contract prior to death to the extent that the cash surrender value exceeds the policyholder's investment in the contract, i.e., the sum of all premiums paid on the contract. Gross income does not include amounts received by a beneficiary under a life insurance contract, if the amounts are paid because of the death of the insured.

In TEFRA, Congress enacted temporary guidelines for determining whether flexible premium life insurance contracts (e.g., universal life or adjustable life) qualified as life insurance contracts for purposes of the exclusion of death benefits from income. Violation of the guidelines at any time during the contract caused the contract to be treated as providing a combination of term life insurance and an annuity or a deposit fund (depending on the terms of the contract). In the event of the death of the insured, only the term life insurance component is excluded from gross income.

1982 and 1983 temporary guidelines

Under the temporary guidelines which apply to contracts issued in 1982 and 1983, death proceeds from flexible premium life insurance contracts are treated as life insurance if either of two tests are met.

Alternative 1

Under the first of the two alternative tests, a contract qualifies if:

(a) The sum of the premiums paid for the benefits at any time does not exceed the net single premium (based on interest rates at 6 percent) or the sum of the net level premiums (based on interest rates at 4 percent), assuming the policy matures no earlier than in 20 years or at age 95, (if earlier); and

(b) the death benefit is at least 140 percent of cash value at age 40, phasing down one percentage point each year to 105 percent.

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[49] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 221; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1442-1450; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 221; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 571-580; and H. Rep. No. 98-861 (June 23, 1984), pp. 1074-1076 (Conference Report).

Alternative 2

Under the second of the two alternative tests, a contract qualifies if the cash surrender value does not exceed the net single premium (based on interest rates at 4 percent and the most recent mortality table) for the amount payable at death, assuming the policy matures no earlier than age 95.

Explanation of Provision

The Act adopts a definition of a life insurance contract for purposes of the Internal Revenue Code. This provision extends to all life insurance contracts rules that are similar to those contained in the temporary provisions of TEFRA. Because there was a general concern with the proliferation of investment-oriented life insurance products, the definition was narrowed in some respects.

Definition of life insurance

A life insurance contract is defined as any contract, which is a life insurance contract under the applicable State or foreign law, but only if the contract meets either of two alternatives: (1) a cash value accumulation test, or (2) a test consisting of a guideline premium requirement and a cash value corridor requirement. Whichever test is chosen, that test must be met for the entire life of the contract in order for the contract to be treated as life insurance for tax purposes. The choice of test will be evident on issuance of the contract. Because the cash value accumulation test must be met at all times *by the terms of the contract*, failure of a contract meeting this requirement will mean that the contract must meet, at all times, the guideline premium/cash value corridor test.[50] Rather than being a requirement on the terms of the contract, the latter test (guideline premium/cash value corridor test) is one that is applied in practice and calls for specific corrective actions if a contract fails to meet it at any time. Although the guideline premium/cash value corridor test does not have to be met by the terms of the contract, the test limitations could be built into a contract to make compliance therewith automatic and to avoid inadvertent violation of those test limitations.

The term "life insurance contract" does not include that portion of any contract that is treated under State law as providing any annuity benefits other than as a settlement option. Thus, although a life insurance contract may provide by rider for annuity benefits, the annuity portion of the contract is not part of the life insurance contract for tax purposes and such annuity benefits may not be reflected in computing the guideline premiums. Thus, an insurance arrangement written as a combination of term life insurance with an annuity contract, or with a premium deposit fund, is not a life insurance contract for purposes of the alternative tests because all of the elements of the contract are not treated under State law as

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[50] A change from the guideline premium test to the cash value accumulation test may occur, however, in those limited circumstances under which a contract need not continue to meet the guideline premium test because by the election of a nonforfeiture option, which was guaranteed on issuance of the contract, the contract meets the cash value accumulation test by the terms of the contract. However, any reinstatement of the original terms of such a contract would also reinstate the application of the original guideline premium test to the contract.

providing a single integrated death benefit. As a result, only the term portion of any such contract can meet the tests and be treated as life insurance proceeds upon the insured's death. However, any life insurance contract that is treated under State law as a single, integrated life insurance contract and that satisfies these tests will be treated for Federal tax purposes as a single contract of life insurance and not as a contract that provides separate life insurance and annuity benefits. For example, for purposes of this definition, a whole life insurance contract that provides for the purchase of paid-up or deferred additions is treated as a single life insurance contract.

In the case of variable life insurance contracts (as defined in sec. 817), the determination of whether the contract meets the cash value accumulation test, or meets the guideline premium requirements and falls within the cash value corridor, must be made whenever the amount of the death benefits under the contract change, but not less frequently than once during each 12-month period. Further, if a contract is checked to see if it satisfies the requirements once a year, the determination must be made at the same time each year.

Cash value accumulation test

The first alternative test under which a contract may qualify as a life insurance contract is the cash value accumulation test. This test is intended to allow traditional whole life policies, with cash values that accumulate based on reasonable interest rates, to continue to qualify as life insurance contracts. Certain contracts that have been traditionally sold by life insurance companies, such as endowment contracts, will not continue to be classified as life insurance contracts because of their innate investment orientation.

Under this test, the cash surrender value of the contract, by the terms of the contract, may not at any time exceed the net single premium which would have to be paid at such time in order to fund the future benefits under the contract assuming the contract matures no earlier than age 95 for the insured. Thus, this test allows a recomputation of the limitation (the net single premium) at any point in time during the contract period based on the current and future benefits guaranteed under the contract at that time. The term future benefits under the Act means death benefits and endowment benefits. The death benefit is the amount that is payable in the event of the death of the insured, without regard to any qualified additional benefits.

Cash surrender value is defined in the Act as the cash value of any contract (i.e., any amount to which the policyholder is entitled upon surrender and, generally, against which the policyholder can borrow) determined without regard to any surrender charge, policy loan, or a reasonable termination dividend. For these purposes, termination dividends are considered reasonable based on what has been the historical practice of the industry in paying such dividends. Historically, termination dividends have been modest in amount. For example, the Congress understood that New York State prescribes a maximum termination dividend of $35 per $1,000 of face amount of the policy. Just as termination dividends are not reflected in the cash surrender value, any policyholder dividends left on deposit with the company to accumulate interest is not part of the cash surrender value of a contract; interest income on such dividend accumulations is currently taxable to the policyholder because the amounts are not held pursuant to an insurance or annuity contract. Likewise, amounts that are returned to a policyholder of a credit life insurance policy because the policy has been terminated upon full payment of the debt are not considered part of any cash surrender value because, generally, such amount is not subject to borrowing under the policy.

Whether a contract meets this test of a life insurance contract will be determined on the basis of the terms of the contract. In making the determination that a life insurance contract meets the cash value accumulation test, the net single premium for any time is computed using a rate of interest that is the greater of an annual effective rate of 4 percent or the rate or rates guaranteed on the issuance of the contract. To be consistent with the definitional test reference to the cash surrender value, the "rate or rates guaranteed on the issuance of the contract" means the interest rate or rates reflected in the contract's nonforfeiture values (i.e., the cash surrender value), assuming the use of the method in the Standard Nonforfeiture Law.[51] With respect to variable contracts that do not have a guaranteed rate, the 4-percent rate applies. The mortality charges taken into account in computing the net single premium are those specified in the contract or, if none are specified in the contract, the mortality charges used in determining the statutory reserves for the contract.[52]

The statutory reference to the rate or rates of interest guaranteed on the issuance of the contract serves the same role as the "minimum rate or rates" referred to in the TEFRA provision of section 101(f). Thus, although the company may guarantee a higher interest rate from time to time, either by contractual declaration or by operation of a formula or index, generally, the rate guaranteed on the issuance of the contract refers to the floor rate, that is, the rate below which the interest credited to the cash surrender value of the contract cannot fall. The statutory reference to "rate or rates" recognizes that a contract may guarantee different floor rates for different periods of the contract, although each is guaranteed upon issuance and remains fixed for the applicable period for the life of the contract. Likewise, the reference to multiple rates indicates that the comparison of the statutorily prescribed rate (e.g. 4 percent or 6 percent) to the rate or rates guaranteed, and the selection of the higher one, must be done for each period for which an interest rate is guaranteed in the cash surrender value. Specifically, it should be noted that when the initial interest rate guaranteed to be credited to the contract is in excess of the generally applicable floor rate assumed in the contract, the higher initial interest rate is the rate guaranteed on the issuance of the contract with

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[51] Discussions herein relating to the determination of the "rate or rates guaranteed on issuance of the contract" and mortality and other charges are generally applicable for purposes of computing definitional test limitations under both the cash value accumulation test and the guideline premium/cash value corridor test.

[52] The term "mortality charges" refers to the amounts charged for the pure insurance risk, even though they may be labeled differently in the contract (e.g. cost of insurance, monthly deduction, mortality deduction, etc.).

respect to the initial period of that guarantee. *De minimis* guarantees (i.e., guarantees of short durations) in excess of the otherwise assumed floor rates may be ignored in certain situations; generally short-term guarantees (extending no more than one year) will be *de minimis* in the calculation of the guideline level premium, but will not be considered *de minimis* in the calculation of the guideline single premium or the net single premium.

The rate or rates guaranteed on issuance of the contact may be explicitly stated in the contract or may be implicitly stated by a guarantee of particular cash surrender values. Since the rate or rates guaranteed are those reflected in the nonforfeiture/cash surrender values (assuming the use of the Standard Nonforfeiture Method), a company will not be considered to guarantee a lower interest rate by failing to state a mortality charge. In such a case the mortality charges used for statutory reserves will be assumed, and the interest rate or rates implicit in the guaranteed cash surrender values (assuming such charges) will be the rate or rates guaranteed on issuance of the contract. Also, if the contract's nonforfeiture values for any duration are determined by a formula that uses the highest value produced by alternative combinations of guaranteed interest rate or rates and specified mortality (and other) charges, the combination of such factors used, on a guaranteed basis, in the highest cash surrender value for such duration should be used for such duration in determining either the net single premium or the guideline premium limitation. [53]

Finally, the amount of any qualified additional benefits will not be taken into account in determining the net single premium. However, the charge stated in the contract for the qualified additional benefit will be treated as a future benefit, thereby increasing the cash value limitation by the discounted value of that charge. For life insurance contracts, qualified additional benefits are guaranteed insurability, accidental death or disability, family term coverage, disability waiver, and any other benefits prescribed under regulations. In the case of any other additional benefit which is not a qualified additional benefit and which is not prefunded, neither the benefit nor the charge for such benefit will be taken into account. For example, if a contract provides for business term insurance as an additional benefit, neither the term insurance nor the charge for the insurance will be considered a future benefit.

Guideline premium and cash value corridor test requirements

The second alternative test under which a contract may qualify as a life insurance contract has two requirements; the guideline premium limitation and the cash value corridor. The guideline premium portion of the test distinguishes between contracts under which the policyholder makes traditional levels of investment

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[53] For example, under a so-called fixed premium universal life contract, if the cash surrender value on a guaranteed basis (ignoring nonguaranteed factors such as excess interest) is not determined by the guaranteed interest rate and the specified mortality and expense charges used to determine the policy value for some duration, but is instead determined by a secondary guarantee using the guaranteed interest rate and specified mortality and expense charges associated with an alternate State law minimum nonforfeiture value for such duration, the guaranteed interest rate and the mortality and expense charges for the secondary guarantee are to be used with respect to such duration in determining either the net single premium or the guideline premium limitation.

through premiums and those which involve greater investments by the policyholder. The cash value corridor disqualifies contracts which allow excessive amounts of cash value to build up (i.e., premiums, plus income on which tax has been deferred) relative to the life insurance risk. In combination, these requirements are intended to limit the definition of life insurance to contracts which require only relatively modest investment and permit relatively modest investment returns.

The specifics of these requirements are described below.

Guideline premium limitation.—A life insurance contract meets the guideline premium limitation if the sum of the premiums paid under the contract does not at any time exceed the greater of the guideline single premium or the sum of the guideline level premiums to such date. The guideline single premium for any contract is the premium at issue required to fund future benefits under the contract. The computation of the guideline single premium must take into account (1) the mortality charges specified in the contract, or used in determining the statutory reserves for the contract if none is specified in the contract, (2) any other charges specified in the contract (either for expenses or for supplemental benefits), and (3) interest at the greater of a 6-percent annual effective rate or the rate or rates guaranteed on the issuance of the contract. The guideline level premium is the level annual amount, payable over a period that does not end before the insured attains age 95, which is necessary to fund future benefits under the contract.[54] The computation is made on the same basis as that for the guideline single premium, except that the statutory interest rate is 4 percent instead of 6 percent. See also the discussion under the cash value accumulation test relating to "rate or rates guaranteed on issuance of the contract" and guaranteed mortality and other charges for use in computing the definitional test limitations.

A premium payment that causes the sum of the premiums paid to exceed the guideline premium limitation will not result in the contract failing the test if the premium payment is necessary to prevent termination of the contract on or before the end of the contract year, but only if the contract would terminate without cash value but for such payment. Also, premium amounts returned to a policyholder, with interest, within 60 days after the end of a contract year in order to comply with the guideline premium requirement are treated as a reduction of the premiums paid during the year. The interest paid on such return premiums is includible in gross income.

Cash value corridor.—A life insurance contract falls within the cash value corridor if the death benefit under the contract at any time is equal to at least the applicable percentage of the cash surrender value. Applicable percentages are set forth in a statutory table. Under the table, an insured person, who is 55 years of age at the beginning of a contract year and has a life insurance contract

[54] To the extent the guideline level premium includes a charge for an additional benefit that is scheduled to cease at a certain age (i.e., there are discrete payment periods for separate policy benefits), the charges for such benefit should be reflected in a level manner over the period such charges are being incurred. This prevents post-funding of the qualified additional benefit.

with $10,000 in cash surrender value, must have a death benefit at that time of at least $15,000 (150 percent of $10,000).

As the table shows, the applicable percentage to determine the minimum death benefit starts at 250 percent of the cash surrender value for an insured person up to 40 years of age, and the percentage decreases to 100 percent when the insured person reaches age 95. Starting at age 40, there are 9 age brackets with 5-year intervals (except for one 15-year interval) to which a specific applicable percentage range has been assigned. The applicable percentage will decrease by the same amount for each year in that age bracket. For example, for the 55 to 60 age bracket, the applicable percentage falls from 150 to 130 percent, or 4 percentage points for each annual increase in age. At 57, the applicable percentage will be 142.

The statutory table of applicable percentages follows:

In the case of an insured with an attained age as of the beginning of the contract year of:		The applicable percentages shall decrease by a ratable portion for each full year:	
More than:	But not more than:	From:	To:
0	40	250	250
40	45	250	215
45	50	215	185
50	55	185	150
55	60	150	130
60	65	130	120
65	70	120	115
70	75	115	105
75	90	105	105
90	95	105	100

For purposes of applying the cash value corridor and the guideline premium limitation (as well as the computational rules described below), the attained age of the insured means the insured's age determined by reference to contract anniversaries (rather than the individual's actual birthdays), so long as the age assumed under the contract is within 12 months of the actual age.

Computational rules

The Act provides three general rules or assumptions to be applied in computing the limitations set forth in the definitional tests. These rules restrict the actual provisions and benefits that can be offered in a life insurance contract only to the extent that they restrict the allowable cash surrender value (under the cash value accumulation test) or the allowable funding pattern (under the guideline premium limitation). By prescribing computation assumptions for purposes of the definitional limitations, Congress limited the investment orientation of contracts while avoiding the regulation of the actual terms of insurance contracts.

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First, in computing the net single premium under the cash value accumulation test or the guideline premium limitation under any contract, the death benefit is deemed not to increase at any time during the life of the contract (qualified additional benefits are treated in the same way). Thus, a contract cannot assume a death benefit that decreases in earlier years and increases in later years in order to avoid the guideline premium limitation.

Second, irrespective of the maturity date actually set forth in the contract, the maturity date (including the date on which any endowment benefit is payable) is deemed to be no earlier than the day on which the insured attains age 95 and no later than the day on which the insured attains age 100. Thus, the deemed maturity date generally is the termination date set forth in the contract or the end of the mortality table. In applying this rule to contracts that are scheduled to automatically mature or terminate prior to age 95, the benefits should also be deemed to continue to age 95 for purposes of computing both the net single premium and the guideline premium limitations. This 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. Similarly, a contract written with a termination date before age 95 (e.g. term life insurance to age 65), which otherwise satisfies the requirements of section 7702, will qualify as a life insurance contract for tax purposes. Also, an actual contract maturity date later than age 100 (e.g., in the case of contract issued on a mortality basis that employs an age setback for females insureds) will qualify with application of this computational rule.

Third, the amount of any endowment benefit, or the sum of any endowment benefits, is deemed not to exceed the least amount payable as a death benefit at any time under the contract. For these purposes, the term endowment benefits includes the cash surrender value at the maturity date.

Notwithstanding the first computational rule, an increase in the death benefit that is provided in the contract, and which is limited to the amount necessary to prevent a decrease in the excess of the death benefit over the cash surrender value, may be taken into account for purposes of meeting the two definitional tests provided under the Act. Specifically, for a contract qualifying under the guideline premium requirement, this type of increasing death benefit can be taken into account in computing the guideline level premium. Thus, in such a case, the premium limitation is the greater of the guideline single premium computed by assuming a nonincreasing death benefit or the sum of the guideline level premiums computed by assuming an increasing death benefit. In the case of a contract qualifying under the cash accumulation test, the above described increasing death benefit can be taken into account if the cash surrender value of the contract cannot exceed at any time the net level reserve. For this purpose, the net level reserve will be determined as though level annual premiums will be paid for the contract until the insured attains age 95, and the net level reserve is substituted for the net single premium limitation in the cash value accumulation test. These modifications to the computational rules allow the sale of contracts in which the death benefit is defined as the cash surrender value plus a fixed amount of pure life insurance protection.

The special computational rule for certain contracts with increasing death benefits allows flexible premium contracts using the guideline premium/cash value corridor test to have a higher internal rate of investment return than otherwise would be allowed under the general computational rules. Although the special computational rule expands the investment orientation allowed for flexible premium contracts, it does not provide a comparable expansion for contracts using the cash value accumulation test over that which is already allowed under the general computational rules.[55]

Finally, it was understood that in computing actual cash surrender values that rounding differences or other computational variations could produce minor variations in results. For example, it has been standard practice for most companies to round all cash values up to the next whole dollar per thousand of face amounts. This simplifies displays and assures compliance with minimum nonforfeiture standards under State law. Thus, it is expected that, in addition to the application of the above described computational rules, reasonable approximations (e.g., $1.00 per $1,000 of face amount) in the calculation of the net single premium or the guideline premiums will be permitted.

Adjustments

The Act provides that proper adjustments be made for any change in the future benefits or any qualified additional benefit (or in any other terms) under the contract, which was not reflected in any previous determination made under the definitional section. Changes in the future benefits or terms of a contract can occur at the behest of the company or the policyholder, or by the passage of time. However, proper adjustments may be different for a particular change, depending on which alternative test is being used or on whether the changes result in an increase or decrease of future benefits. In the event of an increase in current or future benefits, the limitations under the cash value accumulation test must be computed treating the date of change, in effect, as a new date of issue for determining whether the changed contract continues to qualify as life insurance under the definition prescribed in the Act. Thus, if a future benefit is increased because of a scheduled change in death benefit or because of the purchase of a paid-up addition (or its equivalent), the change will require an adjustment and new computation of the net single premium definitional limitation. Under the guideline premium limitation, an adjustment is required under similar circumstances, but the date of change for increased benefits should be treated as a new date only with respect to the

[55] The discrepancy between the tax treatment of flexible premium contracts and that of the more traditional life insurance products (which is embodied in the differences between the cash value corridor and cash value accumulation test) reflect the general concern over the investment orientation of certain life insurance products and recognition of the fact that for an investment-oriented purchase of traditional life insurance products, the after-tax rate of return can be boosted through the use of the policy loan provisions. Whereas, flexible premium contracts might have slightly more generous limitations under the new definitional provisions, it is generally understood that the owner of such a contract is not able to leverage his investment in the contract, and boost the after-tax rate of return, through the use of policyholder loans.

changed portion of the contract. Likewise, no adjustment shall be made if the change occurs automatically, for example, a change due to the growth of the cash surrender value (whether by the crediting of excess interest or the payment of guideline premiums) or changes initiated by the company. If the contract fails to meet the recomputed limitations, a distribution of cash to the policyholder may be required. Under the Act, the Secretary of the Treasury has authority to prescribe regulations governing how such adjustments and computations should be made. Such regulations may revise, prospectively, some of the adjustment rules described above in order to give full effect to the intent of the definitional limitations.

Further, for purposes of the adjustment rules, any change in the terms of a contract that reduces the future benefits under the contract will be treated as an exchange of contracts (under sec. 1035). Thus, any distribution required under the adjustment rules will be treated as taxable to the policyholder under the generally applicable rules of section 1031. This provision was intended to apply specifically to situations in which a policyholder changes from a future benefits pattern taken into account under the computational provision for policies with limited increases in death benefits to a future benefit of a level amount (even if at the time of change the amount of death benefit is not reduced). If the adjustment provision results in a distribution to the policyholder in order to meet the adjusted guidelines, the distribution will be taxable to the policyholder as ordinary income to the extent there is income in the contract. The provision that certain changes in future benefits be treated as exchanges was not intended to alter the application of the transition rules for life insurance contracts (explained below); Thus, section 7702 will not become applicable to a contract that was issued before January 1, 1985, because a reduction of the contracts future benefits resulted in the application of this adjustment provision. Likewise, this adjustment provision was not intended to repeal indirectly the application of section 72(e) to life insurance contracts.

Endowment contracts treated as life insurance contracts

Endowment contracts which meet the requirements of the definition of a life insurance contract will receive the same treatment as a life insurance contract.

Contracts not meeting the life insurance definition

If a life insurance contract does not meet either of the alternative tests under the definition of a life insurance contract, 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.[56] For this purpose, the income on the contract is the amount by which the sum of the increase in the net surrender value of the contract during the taxable year and the

[56] Under a special rule for correction of errors (new sec. 7702(f)(8)), if it is established to the satisfaction of the Secretary that the requirements of the definitional tests were not met due to reasonable error and reasonable steps are being taken to remedy the error, the Secretary may waive the failure to satisfy the requirements.

cost of life insurance protection provided during the taxable year under the contract exceed the amount of premiums paid less any policyholder dividends paid under the contract during the taxable year. The term premiums paid means the amounts paid as premiums under a contract less amounts to which the rules for allocation between income and investment under annuity and other contracts in section 72(e) apply. Because the income on the contract is treated as received by the policyholder, the income would be a distribution subject to the recordkeeping, reporting, and withholding rules under present and prior law relating to commercial annuities (including life insurance). It is hoped this will provide the policyholder with adequate notice that disqualification has occurred, thus giving some protection against underpayment of estimated taxes.

The income on the contract for all prior taxable years is treated as received or accrued during the taxable year in which a life insurance contract ceases to meet the definition of a life insurance contract. The cost of life insurance protection provided under any contract is the lesser of the cost of individual insurance on the life of the insured as determined on the basis of uniform premiums, computed using 5-year age brackets, as prescribed by the Secretary by regulations, or the mortality charge stated in the contract.

The excess of the amount of death benefit paid over the net surrender value of the contract will be treated as paid under a life insurance contract for purposes of the exclusion from income with respect to the beneficiary.

If a life insurance contract fails to meet the tests in the definition, it will nonetheless be treated as an insurance contract for tax purposes. This insures that the premiums and income credited to failing policies will continue to be taken into account by the insurance company in computing its taxable income. In addition, it insures that a company that issues failing policies continue to qualify as an insurance company.

Effective Date

General effective date

Generally, the new definition of life insurance applies to contracts issued after December 31, 1984. See, however, the discussion below regarding certain increasing death benefit contracts issued after June 30, 1984. Also, the TEFRA provisions for flexible premium contracts (that is, sec. 101(f)) were extended through 1984. For purposes of applying the effective date provisions (new sec. 7702(i) of the Code and secs. 221(b)(c) and (d) of the Act) the issue date of a contract is generally the date on the policy assigned by the insurance company, which is on or after the date the application was signed.[57] With respect to group or master contracts, the date taken into account for any insured is the first date on which the insured is covered under the contract and not the date of the master contract. Thus, except in the case of certain increasing death benefit policies, the law in effect prior to the 1984 Act will apply to any

[57] The use of the date on the policy would not be considered the date of issue if the period between the date of application and the date on which the policy is actually placed in force is substantially longer than under the company's usual business practice.

contract issued during 1984. Also, any product that meets the definitional requirements of new section 7702 will be treated as life insurance if the contract is issued during 1984.

Contracts issued in exchange for existing contracts after December 31, 1984, are to be considered new contracts issued after that date. The exercise of an option or right granted under the contract as originally issued does not result in an exchange and thus does not constitute the issuance of a new contract for purposes of new section 7702 and any applicable transition rules if the option guaranteed terms that might not otherwise have been available when the option is exercised. Similarly, a substitution of insured (for example, in a key man insurance policy) pursuant to a binding obligation will not be considered to create a new contract subject to the terms of section 7702; this treatment would not extend to an individual who becomes a new insured under a group master contract after the effective date of section 7702. In addition, a change in an existing contract will not be considered to result in an exchange, if the terms of the resulting contract (that is, the amount or pattern of death benefit, the premium pattern, the rate or rates guaranteed on issuance of the contract, or mortality and expense charges) are the same as the terms of the contract prior to the change. Thus, a change in minor administrative provisions or a loan rate generally will not be considered to result in an exchange. See also the discussion below on contracts issued pursuant to existing plans of insurance.

Certain increasing death benefit policies issued after June 30, 1984.—The new definitional provisions for life insurance apply to any contract issued after June 30, 1984, if the contract has an increasing death benefit and premium funding more rapid than 10-year level premium payments, unless the contract meets one of three transition rules. An otherwise level death benefit policy is not subject to this earlier effective date merely because the death benefit may increase with the crediting of excess interest or paid-up additions. The premium funding in this instance refers generally to the premium payment pattern and requires that the pattern not allow an annual premium payment by the policyholder in the first 10 years of the policy in excess of the level amount for a 10-pay premium pattern for the increasing death benefit, based on mortality and expense charges and interest rate(s) guaranteed on issuance of the contract.

Increasing death benefit contracts with premium funding more rapid than 10-year level premium payments are not subject to the new definitional provision unless issued after December 31, 1984, if: (1) the contract (whether or not a flexible premium contract) meets the requirements of the temporary provisions for flexible premium contracts (sec. 101(f) enacted in TEFRA); (2) the contract (that is not a flexible premium contract as defined in sec. 101(f)) meets the requirements set forth in the new section 7702 by substituting 3 percent for 4 percent as the minimum interest rate to be used in the cash value accumulation test and the maturity date is deemed to be the latest permitted under the contract (but not less than 20 years after the date of issue or, if earlier, age 95); or (3) the contract meets certain definitional requirements as an irreplaceable life insurance contract.[58]

Certain contracts issued before October 1, 1984.—There is an additional transition rule for certain increasing death benefit policies, which makes the new definitional provisions of new section 7702 applicable only for a contract issued after September 30, 1984, if the contract would meet the new definition by substituting "3 percent" for "4 percent" as the minimum interest rate in the cash value accumulation test (assuming that the rate or rates guaranteed on issuance of the contract can be determined without regard to any mortality charges, and without regard to any initial interest rate guaranteed in excess of the stated minimum rate),[59] and if (with the same "3 percent" for "4 percent" substitution) the cash surrender value of the contract does not at any time exceed the net single premium which would have to be paid at such time to fund future benefits at the then current level of benefits.

Contracts issued pursuant to existing plans of insurance.—Under a transition rule, certain qualified contracts under existing plans of insurance qualify as life insurance contracts under the cash value accumulation test, discussed above, if the contracts would meet the test using 3-percent, instead of 4-percent, as the statutorily prescribed minimum interest rate. A "qualified contract" will mean any contract that requires at least 20 nondecreasing annual premium payments and is issued pursuant to an existing plan of insurance. An existing plan of insurance is any plan of insurance or policy blank that has been filed by the issuing company in one or more States before September 28, 1983.

It is intended that the 20-pay requirement will not be violated by a plan of insurance that provides for the purchase of insurance by means of paid-up additions, if the additional amounts are modest and reasonable compared with the basic benefit under the contract. Similarly it was not intended that administrative changes made as part of the ongoing maintenance of the plan of insurance should result in forfeiture of the special transition rule for existing plans of insurance if the changes do not significantly affect the fundamental terms and economics of contracts sold under such plan. For example, a company may clarify the wording of its contracts, slightly modify its loan rate provisions, conform its contracts to state readability standards, or modify the plan of insurance in order to accommodate other state requirements of an administrative nature. Generally, such modifications will not result in forfeiture of an existing plan of insurance because they do not affect the fundamental terms and economics of the insurance plan described by the amount or pattern of death benefit available, the premium paying patterns available, the rate or rates guaranteed on issuance of the contract, or the mortality and expenses charges to be used.

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[58] That is, under such contract, (i) the premiums (including any policy fees) will be adjusted from time to time to reflect the level amount necessary (but not less than zero) at the time of such adjustment to provide a level death benefit assuming interest crediting and an annual effective interest rate of not less than 3 percent, or (ii) at the option of the insured, in lieu of an adjustment under clause (i), there will be a comparable adjustment in the amount of the death benefit.

[59] This latter point is not presently specified in the statute, but was intended . Also, the special transition rule erroneously refers to a "clause (i)" of subparagraph (A) that does not exist.

There is a further transitional rule for the application of the definition of an existing plan of insurance. That is, a plan of insurance on file in one or more States before September 28, 1983, will continue to be treated as such even though the plan of insurance is modified after September 28, 1983, to permit the crediting of excess interest or similar amounts annually and not monthly. Because of this specific statutory exception, such a change will not result in a forfeiture of the grandfather for an otherwise qualified contract even though it alters the fundamental economics of the plan of insurance.

b. Treatment of certain annuity contracts (sec. 222 of the Act and sec. 72 of the Code) [60]

Prior Law

Cash withdrawals prior to the annuity starting date were includible in gross income to the extent that the cash value of the contract (determined immediately before the amount was received and without regard to any surrender charge) exceeds the investment in the contract. A penalty tax of 5 percent was imposed on the amount of any such distribution that is includible in income, to the extent that the amount is allocable to an investment made within 10 years of the distribution. The penalty was not imposed if the distribution is made after the contractholder attains age 59½, when the contractholder becomes disabled, upon the death of the contractholder or as a payment under an annuity for life or at least 5 years. No income was recognized to the recipient of an annuity on the death of the contractholder. However, since the recipient had the same investment in the contract as the deceased contractholder, the recipient was subject to income tax on the income accumulated in the contract prior to death when it was distributed from the contract.

Explanation of Provision

Penalty on premature distributions

The Act generally retains the prior-law provisions for annuity contracts. However, the 5-percent penalty on premature distributions applies to any amount distributed to the taxpayer, without regard to whether the distribution is allocable to an investment made within 10 years, unless the taxpayer owner has attained age 59½.[61] This is consistent with a general objective of the Act to encourage the use of annuities as retirement savings as opposed to short-term savings.

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[60] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 222; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1450-1451; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 222; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 580-581; and H. Rep. No. 98-861 (June 23, 1984), pp. 1076-1078 (Conference Report).

[61] The Act adopts a technical correction to the TEFRA annuity provisions which allows any investment in a multiple premium annuity contract (issued prior to the effective date of the new penalty provisions) to be treated as having been made on January 1 of the year of investment. This technical correction was intended to simplify the accounting requirements of the 10-year-aging rule in TEFRA for the penalty on early distributions from annuity contracts.

Distribution in event of annuity holder's death

An annuity contract must provide specific rules for distribution in the event of the contractholder's (owner's) death in order to be treated as an annuity contract for income tax purposes. These distribution rules were intended to generally conform to those applicable to qualified pension plans and IRAs. The statutory provision requiring the inclusion of the distribution rules in an annuity contract does not apply to contracts used as part of a qualified pension plan or for an IRA.

To be treated as an annuity contract, the contract must provide that, if the contractholder dies on or after the annuity starting date and before the entire interest in the contract has been distributed, the remaining portion of such interest will be distributed at least as rapidly as the method of distribution in effect. If the contractholder dies before the annuity starting date, generally, the entire interest must be distributed within 5 years after the date of death of the contractholder, or must be annuitized for some period (including the life of a designated beneficiary) within 1 year after that date. For these purposes, the "beneficiary" is the person who becomes the new owner of the annuity contract and controls the use of the cash value of the contract.

If there is a spousal beneficiary upon the contractholder's death, the contract (including deferral of income tax) may be continued in the name of the spouse as the contractholder. Thus, a spousal beneficiary steps into the shoes of the decedent contractholder. If, for example, a husband's interest in an annuity contract passes to his wife on his death and to their minor child on her death (both prior to the annuity starting date), the entire interest in the contract must be distributed within 5 years after the wife's death, or must be annuitized for some period within 1 year after that date.

As with other annuity provisions, to the extent that the terms used refer to individuals (e.g., death, spouse, or age), the provisions are intended to apply only to individual contractholders or owners of annuity contracts.

Illustration of annuity provisions

In making both the TEFRA and the 1984 Act changes to annuity provisions, Congress indicated its view that deferral of tax on investment income of annuities is justified only by the retirement savings purpose of annuities. Hence, many of the rules for annuities now conform generally to those for qualified pension plans and IRAs.[62] Thus, the focus of the application of 5-percent annuity penalty and the distribution-at-death rules is on the contractholder, who controls the beneficial enjoyment of the cash surrender value and enjoys the deferral of tax on income that, except for special tax treatment for annuities, would otherwise be taxable to the holder.

The application of these provisions in the case in which the contractholder and the annuitant (or measuring life) is the same person have the following consequences: Distributions from the contract before the annuity starting date generally will be treated

[62] Note that the treatment of gratuitous transfers for annuity contracts before annuitization does not conform to that for qualified pension plans and IRAs.

as income (to the extent there is income in the contract) and will be subject to the 5-percent penalty (unless the individual contractholder has attained age 59½ or the distribution is part of an annuity for 5 years or longer). If the contractholder dies before the annuity starting date, there must be distributions in accordance with the distribution-at-death rules and such distributions will not be subject to the penalty.

In the case in which the contractholder is a different person than the annuitant the 5-percent penalty and the distribution-at-death rules are applied in a similar manner. For example, assume that a father (age 50) purchases an annuity and is the contractholder, but names his son (age 25) as the annuitant, with annuity payments to begin when the son reaches age 45. Assume further that the father dies at age 58 and the son becomes the contractholder. Under the new provisions, there must be a distribution of the entire interest in the contract within 5 years of the father's death or there must be annuitization of the contract within 1 year of such date. There will be no 5-percent penalty on any part of the distribution because of the penalty exception for distributions caused by death.

Effective Date

These amendments to the annuity rules apply to contracts issued after the day which is six months after the date of enactment (i.e., after January 18, 1985). For these purposes, an annuity contract issued in exchange for another will be considered a new contract subject to the new penalty and distribution-at-death rules. The effective date grandfathers the application of the TEFRA 10-year aging exception for income on contracts issued before January 19, 1985, but does not continue this grandfather benefit for amounts within such a contract if the contract is exchanged for a new contract after January 18, 1985. However, the grandfather provisions granted in TEFRA for amounts invested in or credited to investments in annuity contracts prior to August 13, 1982, continue in effect for purposes of applying the distribution of income-first rules applicable to annuity contracts and nonapplication of the penalty.

c. Certain exchanges of insurance policies (sec. 224 of the Act and sec. 1035 of the Code) [63]

Prior Law

Under prior and present law, no gain or loss is recognized on the exchange of (1) a contract of life insurance for another contract of life insurance or for an endowment or annuity contract; (2) a contract of endowment insurance for another contract of endowment with the same or earlier payment date or for an annuity contract; or (3) an annuity contract for an annuity contract.

For purposes of this exchange rule, an endowment contract is defined under prior law as a contract with a life insurance company (as defined for tax purposes), which contract depended in part on

[63] For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 224; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 581-582; and H. Rep. No. 98-861 (June 23, 1984), pp. 1078-1079 (Conference Report).

the life expectancy of the insured, but which may be payable in full in a single payment during his life. A life insurance contract was defined in the same way as an endowment contract, but as being a contract which was not ordinarily payable in full during the life of the insured.

Explanation of Provision

The Act amends the definition of an endowment contract and a life insurance contract to include contracts issued by any insurance company taxable under subchapter L of the Code, rather than just by life insurance companies. This change in law was intended to recognize that the focus of the exchange rule should be on the character and benefits of the contract rather than the particular tax status of the company issuing the contract. Because of this express intent, the definition of an endowment contract and a life insurance contract should be interpreted as including also those contracts issued by an insurance company that would be taxable under subchapter L, but for a specific tax-exemption under section 501 or some other provision.

Effective Date

The amendment is effective for all exchanges whether before, on, or after the date of enactment.

d. Group-term life insurance purchased for employees (sec. 223 of the Act and sec. 79 of the Code) [64]

Prior Law

Under prior and present law, the cost of group-term life insurance purchased by an employer for an employee for a taxable year is included in the employee's gross income to the extent that the cost is greater than the sum of the cost for $50,000 of life insurance plus any contribution made by an employee to the cost of the insurance. Among the exceptions to this rule under prior law was one that applied to terminated employees who have reached retirement age or are disabled. As a result, an employer could provide group-term life insurance for these two groups of former employees in amounts greater than $50,000 without any portion of the costs being included in their gross income.

If a group-term life insurance plan maintained by an employer discriminates in favor of any key employee, the exclusion for the cost of the first $50,000 of this insurance is further limited. In the case of a discriminatory plan, the full cost of the group-term life insurance for any key employee is included in the gross income of the employee (and, under prior law, was based on the uniform premium table).

The cost of an employee's share of group-term life insurance is determined on the basis of uniform premiums, computed with re-

[64] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 224; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1453-1455; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 223; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 582-583; and H. Rep. No. 98-861 (June 23, 1984), pp. 1079-1080 (Conference Report).

spect to 5-year age brackets. In the case of an employee who has attained age 64, the cost does not exceed the cost for a 63-year old individual.

Explanation of Provision

The Act effects three changes in the prior-law treatment of group-term life insurance. First, the $50,000 limitation on the amount of group-term life insurance that may be provided tax-free to employees applies to retired as well as active employees.[65] The Act does not alter the cost tables under prior law, however, so a retired employee's benefit is computed at the age 63 cost.

Second, the nondiscrimination rules also now apply to plans with respect to coverage of former employees (both retired and disabled). Thus, the cost of group-term coverage that is provided to retired key employees is not subject to any exclusion from gross income if the plan is found to be discriminatory. For purposes of determining whether a plan is discriminatory, insurance coverage for retired employees generally is to be tested separately from insurance for active employees. It was believed that this separate treatment of retired and active employees would be appropriate, because employers often provide lower group-term benefits to retirees. This reduction in benefits under a plan generally reflects a retired employee's reduced need for insurance coverage to replace his or her earning potential. However, this separate treatment of retired and active employees was not intended to prevent the aggregation of plans, generally, when applying the nondiscrimination rules.

Third, under the Act, if a plan fails to qualify for the exclusion because it is discriminatory, then the active and former key employees will have to include in income the actual cost of their insurance benefit rather than the table cost prescribed by the Treasury. The requirement that key employees recognize the actual cost of their coverage was intended to further discourage the use of discriminatory group-term life insurance plans. This requirement would only tend to have this effect if the actual cost exceeds that specified in the uniform premium table. To give full effect to the Congressional intent and not create situations in which the provision might tend to encourage discrimination (i.e., when the actual cost may be less than that specified in the uniform premium table), the cost to be recognized by key employees under discriminatory plans should be the higher of actual cost or the amount specified in the uniform premium table; this policy is not currently reflected in the statute. It is anticipated that Congress will make any technical corrections necessary to clarify this point for the future.

The determination of actual cost may be relatively easy under plans that are broken down on an individual basis (e.g., in situations in which individual policies are used as part of the plan to cover a key employee) or in situations in which the information on the marginal cost for the key employee is obtainable from the company (e.g., because a medical exam was required to obtain coverage). For situations in which the cost for the key employee is not

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[65] The Act does not apply the limitation to those who have terminated employment because of a disability.

readily obtainable (for example, if all employees are covered under a single experience-rated group policy), the cost of the policy will have to be allocated. This allocation must take into account the ages of the covered employees and that of the key employee, possibly using the cost distribution of a published premium table as a guide. It is expected that the identification and allocation of actual cost will be specifically addressed by Treasury in regulations.

Finally, the Act provides a specific exception to the application of section 83 so that the cost of the group-term life insurance coverage will be included in the income of a retired employee for the year in which the coverage is received, whether or not the benefit of retirement coverage vests upon retirement. Although this provision was intended to clarify when the group-term life insurance benefit for a retired employee is included in income, it was not intended to affect in any way the determination of whether the form of the benefit received by an employee upon retirement constitutes group-term life insurance (or a permanent benefit) for purposes of section 79.

Effective Date

In general, the amendments made by this section apply to taxable years that begin after December 31, 1983.

The new provisions extending the $50,000 limitation and the nondiscrimination rules do not apply to any group-term life insurance plan in existence on January 1, 1984, or to any group-term life insurance plan of the employer (or successor employer) which is a comparable successor to an existing plan, but only with respect to an individual who retires under the plan, who was employed during 1983 by the employer having the plan, and who attained age 55 on or before January 1, 1984. These provisions were not intended to apply to any employees who retired before January 1, 1984 (whether or not they had attained age 55 as of that date).

Generally, the term employer may be interpreted broadly to allow employee transfers between comparable plans offered by an affiliated group. Also, for these purposes a successor employer refers to a situation in which an employer assumes the group-term insurance obligations of another employer because of a business merger or acquisition, but does not refer to a new employer when an individual covered by a plan changes jobs and becomes covered by the new employer's group-term insurance plan. It was intended that an employee would be treated as employed by the employer in 1983, if the employee was employed by the predecessor to the employer having the plan. This could occur, for example, when an employee retires from an employer who was "spun-off" from a predecessor employer after 1983. Also, an existing plan that is modified after 1983 will be considered a comparable successor plan if the modifications merely result in the reduction or elimination of insurance for some employees in order to make the existing plan nondiscriminatory or to meet other provisions under the Code.[66]

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[66] Colloquy between Senators Armstrong and Dole, 130 Cong. Rec. S4563 (daily ed. April 12, 1984).

The provision grandfathering certain plans with respect to certain employees will not itself apply to any plan which is discriminatory after December 31, 1986, with respect to any individual retiring after that date. If any plan is discriminatory after December 31, 1986, any grandfather protection (i.e., the nonapplication of the $50,000 limitation) with respect to retired employees who were age 55 or older on January 1, 1984, and who retire after December 31, 1986, will be lost for the plan completely, not just for key employees. For purposes of whether a plan meets the nondiscrimination requirements, coverage provided to employees who retired on or before December 31, 1986, will not be taken into account.

4. Studies (sec. 231 of the Act) [67]

Two issues that were of concern during the entire process of reformulating the tax structure applicable to life insurance companies were (a) the amount of Federal income tax paid by the companies in the life insurance industry and (b) the relative income tax burden borne by mutual and stock companies. The Congress wanted to maintain close scrutiny of these two matters, and thus instructed that analytical reports be prepared on these two subjects.

Revenue reports

Each year on July 1, beginning in 1985, the Secretary of the Treasury must submit a report on the revenues received under the provisions of part I, subchapter L for the most recent taxable year. The report is to be submitted to the Committee on Ways and Means and the Committee on Finance. Each report will present the aggregate amount of revenue received for the most recent taxable year for which data are available. The revenues are to be compared with the revenue estimates anticipated as a result of the changes made by TEFRA in 1982 and the 1984 Act. The reasons for any difference between the actual aggregate revenues and the revenues anticipated when the Acts were adopted are to be presented and analyzed.

Report on segment balance and other issues

The impact of new part I, subchapter L on the different segments and products of the life insurance industry needs to be examined. The Secretary of the Treasury, in consultation with the House Committee on Ways and Means, the Senate Committee on Finance, and the Joint Committee on Taxation, is instructed to conduct a full and complete study of the effects of the provisions in this Act to examine the operation of the new tax provisions during 1984, 1985, and 1986.

The study must include an analysis of the relative shares of life insurance company taxes paid by mutual and stock life insurance companies. The study also will consider any other data considered

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[67] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 241; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1460-1461; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 231; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 584-585; and H. Rep. No. 98-861 (June 23, 1984), pp. 1080-1081 (Conference Report).

to be relevant by either stock or mutual life insurance companies in determining appropriate segment balance. Among the relevant variables for consideration are the amounts of the following items held by each segment of the industry: equity; life insurance reserves; other types of reserves; dividends paid to policyholders and shareholders; pension business; total assets, and gross receipts. Also, in preparing this study, the Treasury is supposed to give specific attention to the revenue impact of allowing consolidated returns to be filed by life insurance companies with nonlife or noninsurance companies. Also, the study is supposed to include an analysis of the extent that taxes paid by stockholders of life insurance companies affect proper evaluation of segment balance.

Finally, the study is supposed to include an analysis of life insurance products and their taxation. In addition, an analysis of whether the tax provisions in part I of subchapter L operate as a disincentive to growing companies will be included.

In order to be able to conduct the study with as complete a fund of information that is possible, the Secretary of Treasury is given authority to require reporting of data necessary for the study by life insurance companies with respect to the companies and their products. Also, it was specifically intended that the general authority granted to Treasury to gather information to study the revenue effect and assess the tax policy adopted under the insurance provisions be used to gather information on the volume and use of policyholder loans so that the committees will have useful information for future legislative work in that area.

The final report on the study is to be submitted by January 1, 1989, to the Committee on Ways and Means and the Committee on Finance. Interim reports are to be submitted to the committees not later than July 1, 1986, 1987, and 1988.

D. Revenue Effect of Life Insurance Tax Provisions

The life insurance tax provisions are estimated to reduce fiscal year budget receipts by $80 million in 1984, $315 million in 1985, $375 million in 1986, $469 million in 1987, $541 million in 1988, and $626 million in 1989.[68]

[68] These amounts represent the estimated effect of the life insurance tax provisions assuming that certain temporary provisions enacted in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), which provide for the taxation of life insurance companies, had been terminated. If these provisions had not been allowed to expire at the end of 1983, the estimates for the life insurance tax provisions in the Act would show increases in fiscal year receipts of $935 million in 1984, $1,050 million in 1985, $1,101 million in 1986, $1,192 million in 1987, and $1,291 million in 1988.

TITLE III—PRIVATE FOUNDATION PROVISIONS [1]

A. Limitations on Deduction for Contributions to Private Foundations (sec. 301 of the Act and Code sec. 170)

Prior Law

Percentage limitations

Under Code section 170, contributions of cash or ordinary-income property by an individual to public charities [2] or private operating foundations [3] are deductible up to 50 percent of the donor's contribution base for the year (adjusted gross income, with certain modifications). The 50-percent limitation applies to contributions of cash or ordinary-income property made by individuals to a private nonoperating (grantmaking) foundation only if the donee either redistributes all contributions within a specified period after receipt or qualifies as a "pooled fund" foundation. A 30-percent limitation applies to contributions of certain capital-gain property [4] to public charities, private operating foundations, and the two special types of nonoperating foundations eligible for the 50-percent limitation in the case of cash gifts.

The percentage limitation was 20 percent under prior law for all other charitable contributions. Thus, in the case of contributions by individuals to private nonoperating foundations (other than the two special types eligible for the 50-percent/30-percent limitations), the percentage limitation under prior law was 20 percent for either cash or property donations.

Carryover of excess contributions

Charitable contributions by individuals which exceed the 50-percent/30-percent limitations may be carried forward and deducted over the following five years, subject to applicable percentage limitations in those years (sec. 170(d)). Under prior law, there was no carryover of excess deduction amounts if the 20-percent limitation applied.

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[1] For legislative background of the provisions of Title III, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, Title III; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1463-87; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, Title III; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 586-609; Senate floor amendment, 130 Cong. Rec. S. 4333 (April 11, 1984); and H. Rep. No. 98-861 (June 23, 1984), pp. 1081-82, 1084-1096, 1100.

[2] The term "public charity" is commonly used to refer to an organization described in sec. 501(c)(3) other than a private foundation as defined in sec. 509.

[3] See note 10, *infra*.

[4] The term "capital-gain property" is commonly used in this context to refer to property all the gain on which would 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. The term "ordinary-income" property is commonly used in this context to refer to property other than capital-gain property.

Contributions of appreciated property

In the case of charitable contributions of certain capital-gain property to public charities, private operating foundations, and the two special types of private nonoperating foundations where the 30-percent limitation applies, the amount of the deduction equals the asset's fair market value at the time of the contribution. Under prior law, in the case of donations by individuals of any type of capital-gain property to private nonoperating foundations as to which the 20-percent limitation applied, the amount deductible equaled the asset's fair market value reduced by 40 percent of the unrealized appreciation (i.e., by 40 percent of the amount by which the value exceeded the donor's basis in the donated property). For a corporate donor, the reduction from fair market value in such cases was 28/46 of the unrealized appreciation (sec. 170(e)(1)(B)(ii)).

Reasons for Change

The Congress believed that the denial under prior law of a carry-over deduction in the case of contributions to private grantmaking foundations exceeding the applicable percentage limitation served no useful objective, but merely required the donor to divide a planned large gift to a nonoperating foundation into smaller amounts contributed over successive years. Accordingly, the Congress concluded that extension of the carryover rules to excess contributions to nonoperating foundations would not be inconsistent with longstanding Federal tax policy that generally provides more favorable treatment for contributions to public charities or operating foundations than for contributions to nonoperating foundations.

Because as a general rule public charities and operating foundations directly carry out charitable functions and programs, expend charitable donations more promptly, and have public involvement, support, and supervision, the Congress concluded that a tax preference for contributions to public charities and operating foundations continues to be appropriate. However, acknowledging the substantial role of many grantmaking foundations in private philanthropy, the Congress believed that the extent of this tax preference should be narrowed by increasing to 30 percent the deduction limitation for gifts by individuals of cash and ordinary-income property to nonoperating foundations.

Finally, the Congress concluded that deductibility at full fair market value for gifts of appreciated capital-gain stock to private nonoperating foundations should be permitted in certain limited circumstances in which the potential for abuse, including overvaluations, may be minimized. However, to facilitate review by the Congress of the actual operation of this new rule, the provision for contributions of certain appreciated stock is scheduled to terminate after 1994.

Explanation of Provisions

Percentage limitations

Cash and ordinary-income property.—The 20-percent limitation which applied under prior law for charitable contributions by individuals to private nonoperating foundations (and for certain other charitable contributions)[5] is increased by the Act to 30 percent in the case of contributions of cash and ordinary-income property.[6]

Capital-gain property.—The Act retains a 20-percent limitation for all charitable contributions of capital-gain property by individuals other than donations of such property to public charities, private operating foundations, or the two special types of nonoperating foundations (described above) that are eligible for the 50-percent limitation in the case of cash gifts. (The 30-percent limitation remains in effect for contributions of capital-gain property to public charities, private operating foundations, and the two special types of nonoperating foundations.) Thus, charitable contributions of capital-gain property to private nonoperating foundations (other than the two special types eligible for the 50-percent limitation in the case of cash gifts), including donations of certain qualified appreciated stock that are deductible under the Act at fair market value, are subject to the 20-percent limitation.

Carryover of excess contributions

Under the Act, the five-year carryover deduction for excess contributions by individuals (sec. 170(d)) is extended to contributions to private nonoperating foundations.

Amount deductible for certain stock

In general.—Under the Act, effective for a limited period, the amount of deduction allowable for charitable contributions to private nonoperating foundations of certain qualified appreciated stock (that constitutes capital-gain property) is the full fair market value of the stock on the date of contribution. Thus, for such donations made during the specified period (July 19, 1984 through December 31, 1994), the reduction rule generally applicable to donations of capital-gain property to nonoperating foundations (sec. 170(e)(1)(B)(ii)) — which limits the amount deductible to the asset's fair market value reduced by 40 percent of the unrealized appreciation (28/46ths for corporate donors) — will not apply to such contributions of qualified appreciated stock.[7]

The term qualified appreciated stock is defined by the Act to mean any stock of a corporation (1) for which (as of the date of the contribution) market quotations are readily available on an established securities market and (2) which is capital-gain property (sec. 170(b)(1)(C)(iv)) for purposes of the charitable contribution deduction rules. To meet the first part of this definition, it is not sufficient merely that market quotations for the stock are readily available (e.g., from established brokerage firms); rather, the market quotations must be readily available on an established securities market.

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[5] The other charitable contributions which had been subject to the 20-percent limitation under prior law were contributions to or for the use of (a) certain organizations of war veterans and their auxiliary units, (b) certain fraternal organizations operating under the lodge system, if the gift is used exclusively for certain exempt purposes, and (c) certain nonprofit cemetery companies, and contributions for the use of public charities or other eligible donees (sec. 170).

[6] In conformity with the charitable contribution provisions in sec. 301 of the Act, technical amendments are made to Code secs. 170(b)(1)(A)(vii), 170(b)(1)(C)(i), and 170(e)(1)(B).

[7] The Act does not change the treatment of contributions of capital-gain property to the two special types of private nonoperating foundations that are eligible for the 50 percent limitation in the case of cash gifts.

Limitation.—The nonreduced deduction under the Act for qualified appreciated stock applies only to the extent that the cumulative aggregate amount of donations (including donations made prior to July 19, 1984) made by the donor to one or more private nonoperating foundations[8] (other than the two special types of such foundations described in sec. 170(b)(1)(E)) of stock in a particular corporation does not exceed 10 percent in value of all the outstanding stock of that corporation. For this purpose, an individual is treated as making all contributions that are made by any member of the the individual's family (as defined in sec. 267(c)(4)).[9]

The nonreduced deduction provision does not apply to contributions of any property other than qualified appreciated stock (that constitutes capital-gain property). Thus, for example, the provision does not apply to contributions of bonds, notes, warrants, or options, whether or not market quotations for such property are readily available on an established market. Similarly, the nonreduced deduction provision does not apply to contributions of interests other than corporate stock, such as partnership interests.

Effective Date

The amendments made by section 301 of the Act with respect to the percentage limitation and carryover rules apply to contributions made in taxable years ending after the date of enactment (July 18, 1984). The special rule for certain contributions of qualified appreciated stock applies to such contributions made after the date of enactment and before January 1, 1995.

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[8] In determining whether the 10-percent limitation has been exceeded in the case of a contribution of stock in a particular corporation made by a donor (or a related person) to a private nonoperating foundation, the contribution is aggregated with all other contributions of stock in that same corporation made by the donor (or related persons) to all other related or unrelated private nonoperating foundations.

[9] Under this provision, family members consist of the donor's ancestors, spouse, brothers and sisters, and children and other lineal descendants.

B. Exemption for Certain Operating Foundations from Excise Tax on Investment Income and Expenditure Responsibility Rules (sec. 302 of the Act and Code secs. 4940 and 4945)

Prior Law

Under prior law, all private foundations (including operating foundations) were subject to a two-percent excise tax on the sum of their gross investment income plus net capital gain, less the expenses of earning such amounts (Code sec. 4940).

In the case of grants to all organizations other than public charities, a private foundation was required to exercise expenditure responsibility over the grant in order to avoid the excise tax on taxable expenditures (sec. 4945).

Reasons for Change

The Congress believed that private operating foundations which have substantial public involvement and are not controlled by disqualified persons should be exempted from the two-percent excise tax on net investment income in section 4940, and that other foundations making grants to such organizations should not be required to comply with the expenditure responsibility rules in section 4945. These changes are intended to assist such public-involvement operating foundations in making direct expenditures for the active conduct of their charitable activities. At the same time, other private foundation rules applicable to these public-involvement operating foundations (such as the prohibitions on self-dealing and taxable expenditures), together with the limitations on disqualified person involvement, should minimize abuse situations.

Explanation of Provision

The Act provides that certain private operating foundations having public involvement and not governed or run by disqualified persons—referred to in the Act as "exempt operating foundations"—are not subject to the two-percent excise tax on investment income (sec. 4940). In addition, the Act provides that grants from other foundations to such public-involvement operating foundations are not subject to the expenditure responsibility rules (sec. 4945).

The Act defines exempt operating foundation to mean, with respect to a taxable year, any private operating foundation[10] if (1)

[10] In general, a private operating foundation is defined (sec. 4942(j)(3)) as a foundation that expends directly for the active conduct of its exempt activities at least 85 percent of the lesser of (a) its adjusted net income or (b) its minimum investment return (i.e., five percent of the value of its investment assets). Also, to qualify as an operating foundation, the foundation must meet one of three tests relating to its use of assets, operating expenditures, or support.Under the first test, at least 65 percent of the assets of the foundation must be devoted directly to the active conduct of its exempt activities or to functionally related businesses. Under the second test, the

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the foundation *either* had private operating foundation status on January 1, 1983, *or* had been publicly supported (under secs. 170(b)(1)(A)(vi) or 509 (a)(2)) for at least 10 taxable years prior to the taxable year; (2) the governing body of the foundation, at all times during the taxable year, consists of individuals at least 75 percent of whom are not disqualified individuals; (3) the governing body of the foundation, at all times during the taxable year, is broadly representative of the general public; and (4) no officer of the foundation is, at any time during the taxable year, a disqualified individual. If a private operating foundation meets all four of these requirements for a particular taxable year, the section 4940 tax does not apply to the foundation's investment income for that year; also, a private foundation that makes a grant to such a public involvement operating foundation which is received by the operating foundation during that particular year is not required to exercise expenditure responsibility over that grant under section 4945(d).[11]

For purposes of these requirements, persons such as a public official acting in his or her capacity as such, an individual appointed to the governing body by public officials acting in their capacities as such, and community leaders (such as educators, civic leaders or clergy) who (considered together) represent a broad cross-section of the views and interests of the general public are considered to be broadly representative of the general public. Also for purposes of these requirements, the Act defines disqualified individual as an individual who is (i) a substantial contributor to the foundation; (ii) an owner of more than 20 percent of the total combined voting power of a corporation, the profits interest of a partnership, or the beneficial interest of a trust or unincorporated enterprise, which corporation, partnership, or enterprise is a substantial contributor to the foundation; or (iii) a member of the family of any individual described in (i) or (ii). For this purpose, the term substantial contributor means a person who is described in section 507(d)(2), and the term family has the meaning given to such term by section 4946(d). In determining ownership in a corporation, etc., for purposes of the definition of disqualified individual, the constructive ownership rules of sections 4946(a)(3) and (4) apply.

Effective Date

The exemption from the section 4940 excise tax for certain public-involvement private operating foundations applies to taxable years of such foundations beginning after December 31, 1984. The exemption from the expenditure responsibility rules applies to grants received by such operating foundations after December 31, 1984.

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organization must normally spend an amount not less than two-thirds of its minimum investment return directly for the active conduct of its exempt activities. Under the third alternative test, the organization must receive at least 85 percent of its support from five or more exempt organizations and from the general public, and not more than 25 percent of the foundation's support may be received from any one exempt organization.

[11] However, the grantor remains subject to other rules under section 4945 with respect to the grant, such as the prohibition on expenditures to influence legislation.

C. Reduction in Section 4940 Excise Tax Where Charitable Payout Meets Certain Distribution Requirements (sec. 303 of the Act and Code sec. 4940)

Prior Law

The Tax Reform Act of 1969 imposed a four-percent excise tax on the net investment income of private foundations, i.e., on the sum of gross investment income (including interest and dividends) plus net capital gain, less expenses of earning such income (Code sec. 4940). The tax was imposed so that foundations would share some of the costs of government, particularly the costs of administering the tax laws relating to exempt organizations. In the Revenue Act of 1978, the Congress reduced the tax rate to two percent, noting that the prior rate had produced more than twice the revenue needed to finance administration by the Internal Revenue Service of the exempt organization provisions of the Code.

Code section 4942 in effect requires a private nonoperating foundation to make qualifying distributions, by the end of the following year, at least equal to five percent of the value of its net investment assets for the year, less the amount of section 4940 tax on the foundation's net investment income for the year. The payout rules under section 4942 do not apply to private operating foundations; however, to qualify for operating status, a private foundation must meet certain payout requirements.[12]

Reasons for Change

The Congress was informed that the amount of taxes collected under section 4940 during fiscal year 1982 totaled approximately $93 million. The Internal Revenue Service estimated that the total costs of administering the combined exempt organization and employee plan programs in fiscal year 1982 were approximately $84.5 million, of which $33.4 million was for exempt organizations and about $51.1 million for employee plans.

Thus, collections from the section 4940 excise tax continue to exceed the costs of administering not only the exempt organization program, but also the employee plan and exempt organization programs combined. The amounts raised by this excise tax are not earmarked for the administration of these programs; rather, they go into general revenues. The amount of funds available to the Internal Revenue Service generally continues to depend on annual Treasury appropriations.

In light of these considerations, the Congress concluded that the rate of the section 4940 excise tax should be reduced from two percent to one percent, but only where there is an equivalent increase

[12] See note 10, *supra*.

in the foundation's qualifying distributions for charitable purposes. In other words, the Congress determined that the tax reduction is to be available only where the foundation makes an "extra" charitable effort equivalent to the decrease in tax revenues, and that this rule applies both to foundations whose base period payouts exceeded the minimum distributable amounts and those whose payouts equaled the minimum distributions required. While this rule introduces some additional complexity in computing the section 4940 tax liability, the Congress believed that the tax rate should be lowered, at a time when there is concern about deficit reduction, only if the benefit of the reduction accrues to the beneficiaries of the foundation's purposes and activities.

Explanation of Provision

The rate of the section 4940 excise tax imposed on the net investment income of a private foundation is reduced for a taxable year from two percent to one percent if the amount of qualifying distributions [13] made by the foundation during that taxable year equals or exceeds the sum of (a) an amount equal to the foundation's assets [14] for such taxable year multiplied by the average percentage payout for the base period, plus (b) one percent of the foundation's net investment income (sec. 4940(c)) for such taxable year.[15]

A foundation's percentage payout is computed for a year by dividing (i) the amount of qualifying distributions made by the foundation during the taxable year, by (ii) the foundation's assets for that taxable year. The average percentage payout for the base period is the average of the percentage payouts for taxable years in the base period.

Because the increase in qualifying distributions required to obtain the tax reduction for a particular taxable year otherwise would increase the base period percentage payout for computing eligibility for the tax reduction in succeeding taxable years, a special adjustment rule is provided to prevent the general computation formula described above from requiring such continually higher payout rates in order to qualify for the reduction in section 4940 tax. Under this special rule, if the amount of section 4940 tax for any taxable year in the base period is reduced by reason of section 303 of the Act, the amount of qualifying distributions made by the foundation during such year is to be reduced for purposes of this computation by the amount of such reduction in tax.

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[13] For this purpose, the term qualifying distribution has the same meaning as in sec. 4942(g).

[14] The assets of the foundation, for this purpose, equal the excess determined under sec. 4942(e)(1), i.e., the excess of (1) the aggregate fair market value of all assets of the foundation other than those which are used (or held for use) directly in carrying out the foundation's exempt purposes, over (2) the acquisition indebtedness with respect to such assets (determined under sec. 514(c)(1) without regard to the taxable year in which the indebtedness was incurred). Fair market value is to be determined pursuant to sec. 4942(e)(2).

[15] Under this new provision, the determination of eligibility for reduction in section 4940 tax for a particular taxable year is made by comparing the amount of qualifying distributions made during that year (i.e., for the *current* taxable year) to an amount based, in part, on a percentage of the foundation's assets for that same year. By comparison, a one-year "lag" is allowed for purposes of the section 4942 minimum distribution requirements; that is, under section 4942, the foundation must pay out the required distributable amount (five percent of net investment assets, less certain taxes) either in the current taxable year for which the computation of the distributable amount is made or in the following taxable year.

In general, the base period is the five taxable years preceding the current taxable year. If a private foundation has not been in existence throughout the preceding five taxable years, the base period consists of the taxable years during which the foundation was in existence. Since a newly formed foundation in its first year of existence does not have any base period years, no reduction in the section 4940 tax is available for the first year, regardless of the amount of qualifying distributions made by the foundation during its first year.

In the case of a private foundation which is a successor to another foundation, the experience of the predecessor is to be taken into account in applying this provision. Treasury regulations are to prescribe rules for applying this provision where there has been a merger, reorganization, or division of a private foundation.

The reduction in the section 4940 tax rate to one percent is not available for a year if the foundation's average percentage payout for the base period is less than five percent (3-1/3 percent in the case of a private operating foundation [16]). This disqualification rule is intended to preclude any reduction in the section 4940 tax if, in the base period, the foundation has incurred liability for tax under section 4942 for failure to satisfy the mandatory distribution requirements. This is because a foundation which failed in the base period to make the minimum required distributions should not be eligible to obtain the benefit of tax reduction merely by increasing its distributions (in an amount at least equal to one percent of net investment income) up to the minimum section 4942 level.

However, in two situations, a nonoperating foundation does not incur liability for section 4942 taxes even though the amount of its qualifying distributions (sec. 4942(g)) does not equal at least five percent of its assets. The first situation results from the fact that under section 4942(d), the distributable amount equals the minimum investment return (five percent of assets) reduced by the sum of any taxes imposed on the foundation for the taxable year under section 4940 and the unrelated business income tax. The second situation results from the fact that under section 4942(i), the distributable amount is further reduced by the amount of any excess distribution carryovers from a prior year. However, since neither the amount of such taxes nor the amount of such carryover distributions is included in the definition of qualifying distributions in section 4942(g), a foundation whose distributable amount is reduced by such taxes or carryover excess distributions does not incur section 4942 tax liability if the amount of its qualifying distributions, while less than the minimum investment return, equals or exceeds the distributable amount as thus computed. It is anticipated that technical corrections will be made to the statutory language so that in these situations, the foundation is not made ineligible for the section 4940 reduction by virtue of the disqualification rule.

Effective Date

The amendments made by section 303 of the Act apply to taxable years beginning after December 31, 1984.

[16] See note 10, *supra*.

D. Amendments to Payout Requirements (secs. 304 and 314(a) of the Act and Code sec. 4942)

Prior Law

The Tax Reform Act of 1969 in effect required private nonoperating (grantmaking) foundations to make qualifying distributions at a specified minimum level. Qualifying distributions include direct expenditures to accomplish charitable purposes and grants to public charities or private operating foundations (Code sec. 4942).[17] Under prior law, reasonable and necessary administrative expenses incurred for such charitable purposes counted, without limitation, as qualifying distributions (sec. 4942(g)(1); Treas. Reg. sec. 53.4942(a)-3(a)(2)(i)).

As enacted in 1969, the payout provision had required nonoperating foundations to make qualifying distributions equal to the higher of (1) the foundation's net income (other than long-term capital gains) or (2) the foundation's minimum investment return—then set at six percent of the fair market value of the foundation's net investment assets, with that rate subject to certain adjustments for post-1970 years. The Tax Reform Act of 1976 substituted a flat five-percent rate for measuring the minimum investment return. In 1981, the Economic Recovery Tax Act repealed the prior-law rule that had required foundations to distribute any excess of net income over the minimum investment return. Thus, under present law, to avoid the section 4942 excise tax for a taxable year, a private nonoperating foundation must make qualifying distributions, by the end of the following year, at least equal to five percent of the fair market value of its net investment assets for the year, reduced by the amount of section 4940 tax and any unrelated business income tax on foundation income, and by carryovers of excess distributions from prior years.

The minimum distribution rules under section 4942 do not apply to private operating foundations. However, to qualify for operating status, a private foundation must meet certain payout requirements.[18]

Reasons for Change

The section 4942 qualifying distribution rules are commonly referred to as the "payout" requirements, reflecting the fundamental underlying intent of the 1969 Act provisions that a reasonable minimum amount must be *paid out* by the foundation to its charitable beneficiaries through grants or direct charitable programs—not

[17] If certain requirements are met, a foundation also may count amounts "set aside" to be paid within five years for a specific project as qualifying distributions in the year set aside (rather than in the year such amounts are actually expended).

[18] See note 10, *supra*.

simply *consumed* internally through expenditures for employee salaries and benefits, rent, meeting and travel costs, legal and accounting fees, and other administrative expenses associated with grantmaking. In accord with this objective, the Congress concluded that a reasonable limitation should be placed on the extent to which grant administrative expenses may be counted in satisfaction of the section 4942 distribution requirements, in order to ensure that at least a substantial portion of the minimum distributable amount of foundation expenditures actually reaches grant recipients who are the intended beneficiaries of the distribution requirements.

While recognizing that some internal costs are necessarily incurred in administering grant programs, the Congress believed that the favorable tax treatment which it has provided to private foundations—the immediate charitable deduction to the donor, and the continuing tax-exempt status of the foundation—rests on the benefits expected to accrue to the public from the active charitable programs directly operated by the foundation or carried on by its grant recipients. To the extent that prior law instead permitted the minimum distribution requirements to be met wholly or in significant part through internal administrative expenses of grantmaking, subject only to a generalized limitation (difficult to enforce in practice) that such expenses be reasonable and necessary, the justification for favorable tax treatment was weakened.

In considering the payout provision of the Act, the Congress noted that subsequent to enactment of the original section 4942 requirements in 1969, the amount of charitable expenditures required of private foundations had been twice reduced. First, the Congress lowered the minimum investment return from six percent (subject to adjustments) of the foundation's net investment assets to five percent. Second, the Congress repealed the requirement that the foundation must pay out all its net income if that amount was higher than the minimum investment return, thereby allowing foundations to accumulate all earnings exceeding the minimum investment return. As a result of these prior amendments, the minimum amount of required foundation expenditures was twice lowered, while prior law still permitted grant administrative expenses to count fully in discharging the foundation's payout requirements. In light of these considerations, the Congress concluded that it was essential to limit the extent to which grant administrative costs could be counted as qualifying distributions, thereby maximizing (without increasing the overall distribution requirement) foundation expenditures in the form of grants or contributions, program-related investments, or expenditures directly for the active conduct by the foundation of exempt activities of the foundation. In addition, the limitation should operate in some instances to increase the efficiency of foundation administration.

In order that the Congress may review the operation of this new provision, the limitation on the extent to which grant administrative expenses may count as qualifying distributions will not apply to taxable years beginning after 1990. The Treasury is to submit a study to the tax-writing committees concerning administrative expenses incurred by grantmaking and operating foundations, on the basis of revised foundation information returns (Form 990-PF) which are to require additional and more detailed information on administrative expenses and other expenditures by foundations. The study is to examine, to the extent practicable, the amount of qualifying distributions which actually reach charitable beneficiaries; the administrative costs of such payouts; the effect of the revised general definition of those administrative expenses which are eligible to be qualifying distributions, subject to the new limitation; and the additional information provided by the revised form concerning categories and types of administrative expenses, and the basis for allocating such expenses among categories of foundation expenditures.

Explanation of Provisions

Grant administrative expenses

General rules

Under the Act, the amount of grant administrative expenses paid during a taxable year which may be taken into account as qualifying distributions may not exceed the excess, if any, of (1) 0.65 percent of the aggregate amount of the net assets[19] of the foundation for the year and for the immediately preceding two taxable years, over (2) the aggregate amount of grant administrative expenses paid during the two preceding taxable years which were taken into account as qualifying distributions.[20] This limitation on the extent to which grant administrative expenses may be counted as qualifying distributions will not apply to taxable years beginning after December 31, 1990.

Definitions

The term grant administrative expenses means any administrative expenses (whether direct or indirect expenses) that are allocable to the making by the foundation of any contribution, gift, or grant (whether to organizations or individuals) that is a qualifying distribution (sec. 4942(g)).[21] If a payment by a foundation is a contribution, gift, or grant that is a qualifying distribution, then all administrative expenses (whether direct or indirect expenses) allocable to the payment are grant administrative expenses.[22] Admin-

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[19] For this purpose, the term net assets means, with respect to any taxable year, the excess determined under sec. 4942(e)(1), i.e., the excess of (1) the aggregate fair market value of all assets of the foundation other than those which are used (or held for use) directly in carrying out the foundation's exempt purposes, over (2) the acquisition indebtedness with respect to such assets (determined under sec. 514(c)(1) without regard to the taxable year in which the indebtedness was incurred). Fair market value is to be determined pursuant to sec. 4942(e)(2).

[20] Under this three-year rolling average computation, the extent to which administrative expenses paid by a foundation, for example, in its taxable year 1989 may be treated as qualifying distributions is determined by taking into account grant administrative expenses paid by, and the net assets of, the foundation in its taxable years 1987, 1988, and 1989.

[21] For purposes of this provision, a set-aside (sec. 4942(g)(2)) which is made for purposes of making a contribution, gift, or grant constitutes a contribution, gift, or grant in the taxable year in which treated as a qualifying distribution, and all administrative expenses allocable to such a set-aside are grant administrative expenses.

[22] Grant administrative expenses include allocable expenses incurred prior to the making of grants (whether or not particular grants are actually awarded), such as in the establishment of a grant program and in the receipt, review, and evaluation of requests or applications for grants; allocable expenses incurred during the term of a grant, such as in the review, administration, supervision, and continuing evaluation of grant programs; and allocable expenses incurred after the term of the grant, such as post-grant review, evaluation, and reporting.

istrative expenses that, without respect to the new limitation, may not be counted as qualifying distributions (e.g., administrative expenses incurred in the production of investment income) are not grant administrative expenses and hence do not enter into the computation of the new limitation.

The term administrative expense includes expenses such as compensation of governing board members (directors, trustees, or the like), officers, and other employees; retirement plan contributions and other employee benefits; employee expense reimbursements; legal, accounting, and other fees paid to professionals or consultants; occupancy costs (e.g., rent, utilities, and real estate taxes); office supplies and materials; travel expenses; interest and taxes (including employment taxes); expenses of conferences, conventions, and meetings; subscription costs for periodicals; and other general overhead. An expense, such as wages paid to the foundation's president or to payroll or bookkeeping employees, that may be allocable both to the making of a qualifying distribution grant and also to other activities (direct operating activities, investment activities, etc.) must be allocated among such activities of the foundation pursuant to a reasonable and consistent method.[23]

The new limitation on the extent to which grant administrative expenses may be counted as qualifying distributions does not apply with respect to either (1) administrative expenses incurred by a foundation directly for the active conduct of its own exempt activities[24] or (2) administrative expenses incurred by a foundation directly in making program-related investments (within the meaning of sec. 4944(c)). For purposes of this rule, the term directly for the active conduct of the foundation's exempt activities has the same meaning as that term has in section 4942(j)(3)(A) and, except as stated in the following paragraph, as in Treas. Reg. secs. 53.4942(b)-1(b)(1) and (b)(2) (as illustrated in Reg. sec. 53.4942(b)-1(d)).

As in effect prior to enactment of the Act, Treasury regulations provided, solely for purposes of the definition of an operating foundation under section 4942(j)(3), that all administrative expenses (such as staff salaries and traveling expenses) necessary to conduct a foundation's exempt activities, regardless of whether they are directly for the active conduct of its own exempt activities, are treated as qualifying distributions expended directly for the active conduct of such exempt activities if such expenses and costs are rea-

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[23] As described below, the revised foundation information return (Form 990-PF) is to require the foundation to attach a statement of the accounting principles and practices by which it allocates administrative expenses among various categories of administrative expenses, such as grant administrative expenses, investment administrative expenses, etc.

[24] For example, if one direct charitable activity of a private foundation is to provide direct assistance, through its own employees, to other charities in conducting their own charitable programs and in their fund raising, the salary of an employee of the foundation while he or she performs such work at the location of the other charity for a period of time does not constitute a grant administrative expense. (Of course, all administrative expenses allocable to making grants are subject to the new limitation regardless of whether the expenses are incurred on the foundation's premises or elsewhere.) As a further example, if a foundation which makes grants to individuals also as a direct charitable activity holds seminars or conferences in which the grants recipients participate (e.g., where a foundation which makes research grants to university scientists holds a conference at which the scientists mutually report on their research studies), the administrative expenses shown by the foundation to be incurred by the foundation in directly conducting such conference generally are not grant administrative expenses; all other administrative expenses incurred in the foundation's program of making research grants are grant administrative expenses.

sonable in amount (Reg. sec. 53.4942(b)-1(b)(1)). Of course, this special allocation rule does not apply for purposes of the new limitation enacted in the Act; instead, the only exempt-activity administrative expenses that are not subject to the new limitation in the Act are those incurred (without reference to that special allocation rule) directly for the active conduct by the foundation of exempt activities of the foundation or directly in making program-related investments.[25]

By way of illustration, assume that X Foundation is a private nonoperating foundation whose principal purpose is to relieve poverty and human suffering. The Foundation has a salaried staff of employees located in various areas of the country. Seventy-five percent of the Foundation's expenditures consist of grants to other charitable organizations; the remaining expenditures are incurred in operation by the Foundation of a soup kitchen and other direct delivery services (e.g., the furnishing by the Foundation of temporary shelter to homeless individuals). Under the Act, all direct and indirect administrative expenses incurred by the X Foundation that are allocable to its grantmaking activities are grant administrative expenses. The direct and indirect administrative expenses incurred by the X Foundation that are allocable to the Foundation's operation of the soup kitchen and other direct delivery services performed by the Foundation are not grant administrative expenses for purposes of the new limitation.

Other rules

Under a transitional rule, the amount of grant administrative expenses in any base period year which began before January 1, 1985 is treated as constituting no more than 0.65 percent of the foundation's net assets [26] for that year. For example, if during 1983 the actual grant administrative expenses of a calendar-year foundation amounted to 0.75 percent of net assets, the computation of the limitation for 1985 would assume that the percentage for 1983 was only 0.65 percent.

The new limitation on the treatment of certain administrative expenses as qualifying distributions applies with respect to the definition of qualifying distributions under Code section 4942 and does not affect other foundation tax rules applicable to payments of expenses by a private foundation. Thus, the payment of excessive compensation to a foundation manager constitutes an act of self-dealing under section 4941(d) and a taxable expenditure under section 4945(d)(5), without regard to the treatment of such expenses under section 4942.[27] The mere fact that a State attorney general,

[25] Also, the new limitation in the Act modifies the rule set forth in Reg. sec. 53.4942(b)-(1)(b)(1) for purposes of the minimum distribution test that is part of the definition of an operating foundation in section 4942(j)(3). That is, the new limitation restricts the extent to which grant administrative expenses may be treated, under the regulation, solely for section 4942(j)(3) definitional purposes as expenses incurred directly for the active conduct of exempt activities.

[26] See note 19, *supra*.

[27] Under sec. 4942(g)(1)(A), the excess compensation amount cannot constitute a qualifying distribution, without regard to the new limitation on the treatment of grant administrative expenses as qualifying distributions. Of course, the fact that in a particular case the total of all grant administrative expenses of a private foundation (whether or not otherwise qualifying distributions) would not exceed the new limitation does not in any way preclude examination by the Internal Revenue Service of whether such amount includes excessive compensation, taxable expenditures, etc.

or other State government official, has approved the amount of director fees or other expenditures paid by a foundation does not establish that such amounts or expenditures are reasonable or necessary for purposes of any of the private foundation tax provisions, including sections 4941, 4942, and 4945. On the other hand, the mere fact that the actual amount of a foundation's grant administrative expenses exceeded the new limitation will not itself establish that any amount of such expenditures constitute, for example, excessive compensation under section 4941(d)(2)(E) or taxable expenditures under section 4945(d)(5).

Special computation rules

Under the charitable deduction rules, contributions by individuals to a private nonoperating foundation receive certain favorable treatment if the foundation makes qualifying distributions (which are treated as corpus distributions) equal to 100 percent of the amount of contributions received in the year within 2-1/2 months after the close of that year (secs. 170(b)(1)(D)(ii), 170(e)(1)(B)(ii)). For purposes solely of determining qualifying distributions under these deduction rules relating to such "conduit" foundations, the Treasury is authorized to prescribe by regulations that the grant administrative expense limitation is to be expressed as 15 percent of the amount of such pass-through contributions, and to prescribe in the regulations any necessary or desirable conforming and coordinating rules with respect to the section 4942 limitation which is expressed as a percentage of the foundation's net investment assets. Because such conduit nonoperating foundations may not hold any investment assets, application of the grant administrative expense limitation in terms of a percentage of net assets could result in not allowing any amount of grant administrative expenses of the foundation to count as qualifying distributions; such a result, in turn, could preclude the foundation from eligibility under the special deduction rules if it incurred grant administrative expenses.

In several instances arising prior to enactment of the new limitation, a donor has established a charitable trust (generally treated as a private foundation under sec. 4947) having as its sole beneficiary a private foundation also established by the donor. In such situations, where the trust holds all or substantially all the investment assets the income from which funds the grants that are made by the foundation, separate application to each entity of the grant administrative expense limitation expressed in terms of a percentage of net assets could result in not allowing as qualifying distributions any amount of such expenses incurred by the foundation in its grantmaking activities or only a small portion of such expenses that otherwise would be treated as qualifying distributions under the limitation had the donor combined the trust and foundation into one entity. It is intended that in these limited situations, the trust and foundation are to be treated as one entity for purposes of the grant administrative expense limitation in the Act.

General limitation

Section 304(a)(2) of the Act modifies Code section 4942(g)(1) to clarify that, as specified in Treas. Reg. sec. 53.4942(a)-3(a)(2)(i), any administrative expense (whether or not a grant administrative expense) may count as a qualifying distribution only if and to the extent that the expense is necessary to accomplish the foundation's exempt purposes and is reasonable in amount. (In the case of grant administrative expenses satisfying this requirement, such expenses count as qualifying distributions only to the extent allowed by the new limitation described above.) The mere fact that a particular administrative expense does not constitute an expense for the production of income (sec. 212) or an expense allocable to an excise tax imposed for failure to comply with a private foundation provision (e.g., an expense allocable to making a taxable expenditure) does not establish that the expense is necessary for conducting the foundation's exempt activities and hence can be counted, if reasonable in amount, as a qualifying distribution (subject, in the case of grant administrative expenses, to the limitation described above).

Return information; study by Treasury

The Internal Revenue Service is authorized and directed by the Congress to modify the foundation information return (Form 990-PF) as soon as practicable to require additional and more detailed information on expenditures by nonoperating and operating foundations, both by categories of expenditures (such as grants, direct operating expenditures, program-related investments, other investments, administrative expenses, etc.) and by types of administrative expenses (e.g., separate line items within each of such categories for salaries, rent, legal fees, accounting fees, consulting fees, utilities, traveling expenses, etc.). The revised form is to require the foundation to attach a statement of the accounting principles and practices by which it allocates administrative expenses among those which satisfy the definition of qualifying distributions as modified by the Act (sec. 4942(g)(1)(A)) and other administrative expenses, and among categories of administrative expenses (such as grant administrative expenses, etc.).

The Treasury is to submit a study to the tax-writing committees by January 1, 1988 concerning administrative expenses incurred by nonoperating and operating foundations, on the basis of the revised forms. (If sufficient return data is not available in time for a useful study to be completed by that date, the Treasury is to so notify the tax-writing committees and to suggest an extended due date for the study.) To the extent practicable, the study is to examine (1) the amount of qualifying distributions which actually reach charitable beneficiaries; (2) the administrative costs of such payouts; (3) the effect of the revised general definition (sec. 4942(g)(1)(A)) of those administrative expenses which are eligible to be qualifying distributions, subject to the new limitation; and (4) the additional information provided by the revised form concerning categories and types of administrative expenses, and the basis for allocating such expenses among categories of foundation expenditures. This study is intended to provide more detailed information concerning foundation qualifying distributions than is now available.

Technical amendments

In 1981, section 4942 was amended to define the required minimum distributable amount as five percent of the value of the foundation's net investment assets (rather than as the higher of that figure or net income). The 1981 amendment failed to add back to the newly defined distribution amount the previously applicable modifications set forth in section 4942(f)(2)(C), relating to (i) repayments to the foundation of amounts previously treated as qualifying distributions (e.g., scholarship loans); (ii) amounts received on disposition of assets previously treated as qualifying distributions; and (iii) amounts previously set aside for a charitable project but not so used. Section 304(b) of the Act adds to the definition of the distributable amount in section 4942(d)(1) the amounts specified in Code section 4942(f)(2)(C) (certain loan repayments, proceeds from asset dispositions, and unused set-asides).

Section 314(a) of the Act also makes technical amendments correcting cross-references in Code sections 4942(a)(2)(B), 4942(f)(1), and 6501(n)(3).

Effective Date

The amendments made by section 304 of the Act apply to taxable years beginning after December 31, 1984. The limitation on the extent to which grant administrative expenses may be counted as qualifying distributions will not apply to such expenses in taxable years beginning after December 31, 1990.

The amendments made by section 314(a) of the Act, correcting certain cross-references, are effective on the date of enactment (July 18, 1984).

E. Abatement of First-Tier Excise Taxes in Certain Cases (sec. 305 of the Act and new Code sec. 4962)

Prior Law

First-tier sanctions

In general, violations of the private foundation rules (secs. 4941-4945) result in imposition of an initial excise tax on the foundation (or in the case of self-dealing, on the disqualified person who entered into the prohibited transaction with the foundation). For example, violations of the prohibitions on self-dealing transactions or jeopardizing investments trigger excise taxes equal to five percent of the amount involved in the self-dealing transaction (sec. 4941) or the jeopardizing investment (sec. 4944), payable for each year (or part thereof) in the taxable period. This means that the tax under section 4941 or 4944 continues to be imposed each year beginning when the prohibited act occurs and ending only when the Internal Revenue Service issues a deficiency notice or assesses tax on the act, or when the prohibited act is "corrected."

Under prior law, the initial (first-tier) excise tax on the foundation (or on the disqualified person engaged in self-dealing) applied automatically when a foundation rule was violated. However, where a nonwillful failure to satisfy the section 4942 payout requirements results solely from an incorrect asset valuation which was due to reasonable cause, the excise tax under that section is excused if the payout deficiency is made up during a specified period (sec. 4942(a)(2)).

If there is a violation of the prohibitions on jeopardizing investments, taxable expenditures, or self-dealing, an initial excise tax is imposed on any foundation officer, director, trustee, or responsible employee who knowingly participated in the prohibited act, unless the manager's participation in the act was not willful and was due to reasonable cause. This first-tier tax on the manager cannot exceed $5,000 ($10,000 in the case of self-dealing) for any one such violation.

Second-tier sanctions

If a violation of the foundation rules (secs. 4941-4945) is not corrected within a specified period, an additional (second tier) excise tax is imposed on the foundation (or in the case of self-dealing, on the disqualified person). For example, a second-tier tax equal to 200 percent of the amount involved in a self-dealing transaction would be imposed on the disqualified person unless (1) the prohibited transaction is undone to the extent possible and (2) the foundation is placed in a financial position not worse than it would be had the disqualified person dealt with the foundation under the highest fiduciary standards.

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Similarly, a second-tier excise tax is imposed on a foundation manager who refuses to agree to correct a violation of the prohibitions on self-dealing, jeopardizing investments, or taxable expenditures. The second-tier tax on the manager cannot exceed $10,000 for any one such violation.

Additional penalties

If a foundation rule violation is willful and flagrant,[28] or if there has been a prior violation of any foundation rule, the excise tax sanctions are doubled, unless the violation was due to reasonable cause (sec. 6684). In addition, a termination tax (sec. 507) may be imposed on the foundation if the violation was willful and flagrant or there have been "willful repeated"[29] violations.

Reasons for Change

The Congress believed that in certain limited circumstances not involving willful neglect of the tax rules, the operation of the automatic first-tier penalties under prior law was stricter than needed for purposes of effectively enforcing the private foundation requirements and prohibitions, other than in cases of self-dealing. Therefore, in those instances where the foundation or foundation manager can establish that there was reasonable cause for such a violation and that there was no willful neglect of the rules, the Internal Revenue Service is to have discretionary authority to relieve the foundation or manager from the first-tier penalty tax, provided that the violation is corrected in the manner required in order to avoid liability for second-tier taxes. The Congress concluded that there was no justification for extending an abatement mechanism to acts of self-dealing, particularly since the penalty tax for such violations is payable by the self-dealer, not by the foundation, and since under current law commercial transactions between disqualified persons and foundations are generally prohibited. As with enactment of the 1969 Act provision, the Congress believed that the highest fiduciary standards require complete elimination of all self-dealing transactions, and that the self-dealing rules and sanctions are essential to preclude the misuse of private foundations for noncharitable purposes.

Explanation of Provision

The Act provides discretionary authority to the Internal Revenue Service not to assess, or to abate or refund, any initial (first-tier) tax imposed by subchapter A of chapter 42, other than the section 4941(a) tax on self-dealing, if the foundation or foundation manager establishes to the satisfaction of the Revenue Service that the violation of the foundation rules (1) was due to reasonable cause, (2) was not due to willful neglect, and (3) has been corrected (in the

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[28] An act or failure to act violating a foundation rule is deemed willful and flagrant if it is "voluntarily, consciously, and knowingly" committed in violation of any such rule and if it "appears to a reasonable man to be a gross violation ***" (Treas. Reg. sec. 1.507-1(c)(2)). No motive to avoid the foundation restrictions is necessary to make an act or failure to act willful. However, an act or failure to act is not willful if the foundation (or a manager, if applicable) does not know that it is an act to which the foundation rules apply (Treas. Reg. sec. 1.507-1(c)(5)).

[29] For this purpose, the term willful repeated violations means at least two acts or failures to act both of which are "voluntary, conscious, and intentional" (Treas. Reg. sec. 1.507-1(c)(1)).

manner required by the particular statutory provision in order to avoid second-tier tax) within the appropriate correction period.[30] A violation which was merely due to ignorance of the law cannot qualify for such abatement.

Effective Date

The amendments made by section 305 of the Act apply to taxable events first occurring after December 31, 1984. No abatement is available with respect to a private foundation excise tax liability imposed for a transaction, investment, expenditure, or other act (e.g., the making of a particular jeopardizing investment under sec. 4944) which first occurred prior to January 1, 1985, but which continues to trigger first-tier excise taxes after December 31, 1984 because the transaction, etc. which is the subject matter of the tax liability had not been corrected prior to 1985 (e.g., where the foundation retains the jeopardizing investment after 1984).

[30] The Act makes conforming amendments to the heading and table of sections for subchapter C of chapter 42, to the table of subchapters for chapter 42, and to certain cross-references.

F. Definition of Family Member (sec. 306(a) of the Act and Code sec. 4946(d))

Prior Law

The tax rules applicable to private foundations in effect prohibit certain transactions or holdings involving a disqualified person and a private foundation. The term disqualified person includes substantial contributors to a foundation, foundation officers, directors, or trustees, and members of the family of such an individual, plus certain other related entities (sec. 4946(d)). Prior law defined the disqualified family members as the individual's spouse, ancestors, and all lineal descendants (and their spouses).

Reasons for Change

The Congress believed that, weighing the difficulties of keeping track in perpetuity of all lineal descendants of a disqualified person against the need to preserve the integrity of the foundation rules, it is appropriate to limit the class of lineal descendants who are disqualified persons by reason of being members of a disqualified person's family to children, grandchildren, and great-grandchildren (and their spouses).

Explanation of Provision

The Act limits the lineal descendants of a disqualified person who are considered members of the family of that individual, and as such, also considered to be disqualified persons, to the individual's children, grandchildren, and great-grandchildren, and the spouses of such descendants.

Effective Date

The amendment made by section 306(a) of the Act takes effect on January 1, 1985. If on that date an individual has disqualified person status solely because he or she is a lineal descendant (or spouse thereof) of a disqualified person, other than as a child, grandchild, or great-grandchild (or spouse thereof) of such disqualified person, that individual ceases to be treated as a member of the family of the disqualified person (and as a disqualified person by virtue of such relationship) beginning January 1, 1985.

G. Public Disclosure and Accessibility of Information on Foundations to Grant Applicants (sec. 306(b) of the Act and Code sec. 6104(d))

Prior Law

Annual returns

A private foundation must file an annual information return (Form 990-PF) with the Internal Revenue Service and furnish a copy of the return to the Attorney General (or other official) in the relevant State (sec. 6033).

The Form 990-PF includes the following information for the taxable year: gross income and related expenses, disbursements, a balance sheet showing assets, liabilities, and net worth, total contributions and gifts received, the names and addresses of all substantial contributors, the names and addresses of the foundation managers and highly compensated employees, and the compensation and other amounts paid to the foundation managers and highly compensated employees. Also, the return currently requests certain information regarding applications for grants from the foundation, including the name, address, and telephone number of the person to whom applications should be addressed; any required format, information, and materials; deadlines for submitting applications; and any limitations on the types of awards that the foundation makes, such as by geographical areas, charitable fields, or kinds of donee institutions.

The failure to file a timely exempt organization information return (unless reasonable cause is shown) results in a sanction of $10 per day, up to a maximum of $5,000 as to any one return, imposed on the organization (sec. 6652(d)). Failure to file a return after a written demand by the Internal Revenue Service (unless reasonable cause is shown) results in an additional sanction of $10 per day, up to a maximum of $5,000 as to any one return, imposed on the exempt organization officer or employee who fails to file the information return.

Disclosure requirements

Under present law, all information required to be furnished on the private foundation annual return must be made available to the public by the Internal Revenue Service (sec. 6104).

In addition, a copy of the private foundation annual return must be made available, at the principal office of the foundation, to any citizen who requests to inspect the return within 180 days after a notice of availability has been published (sec. 6104(d)). This notification must be published in a newspaper with general circulation, in the county in which the foundation's principal office is located, not later than the due date for filing the return. The published notice must state the address of the private foundation's principal office and the name of its principal manager. Prior law did not require the notice to state the telephone number of the foundation's principal office.

Finally, the Internal Revenue Service is required to notify the Attorney General (or other official) of the relevant State in the event of (1) denial of tax-exempt status to an organization, (2) the operation of a charitable organization in a manner that fails to meet the requirements for tax-exempt status, or (3) the mailing of a notice of deficiency regarding taxes imposed on private foundations (sec. 6104(c)). In addition, the Service is to make available to such State officials information about the preceding items that are relevant to any determination under State law.

Reasons for Change

The Congress believed that the private foundation reporting and disclosure requirements provide valuable information both for public information purposes and for tax administration purposes. Because the General Accounting Office has concluded that the Internal Revenue Service has not been fully attentive to enforcing the annual return requirements relating to information primarily beneficial to the public, the Congress believed that the Revenue Service should intensify its enforcement activities to ensure availability of this information.

Also, the Congress concluded that the required newspaper notice should include the foundation's telephone number, as an aid to grant applicants.

While the Congress is aware of the various resources presently available to grant applicants, the general public may still experience difficulties in obtaining all information needed about foundation grantmaking. This problem would be alleviated if all private foundations provided the public with information in an accessible and understandable format, for example, through periodic reports made widely available, in addition to the required annual return.

Explanation of Provision

The Act provides that the annual notice of availability of the private foundation annual return, which is required to be published in a newspaper, must contain the telephone number for the foundation's principal office. If the foundation does not have a principal office, or does not have a telephone in its principal office, then the notice must include the telephone number either for the person to whom applications for grants from the foundation must be submitted or, if there is no such person, for the person having custody of the foundation's books.[31]

Also, the Congress directed the Internal Revenue Service to enforce fully the existing rules relating to private foundation annual information returns (Form 990-PF), including the imposition, in appropriate cases, of penalties for failure to file a (complete) return where the return as filed fails to provide all required information.

[31] Under prior and present law, the telephone numbers for both such persons must be listed on the foundation's annual information return, and hence are subject to disclosure to the public.

The Congress also called upon the Revenue Service to facilitate the flow of appropriate information to those State officials who are entitled to such information, and to coordinate more closely with the States to maximize the benefits to be derived from such information.

Effective Date

The amendment made by section 306(b) of the Act takes effect on January 1, 1985. Thus, any notice of availability of the private foundation annual return (as required under sec. 6104) which is published on or after that date must contain the required telephone number.

H. Amendments to Excess Business Holdings Rules (secs. 307-310, 314(b), and 314(c) of the Act and Code sec. 4943)

Prior Law

General rules

In 1969, the Congress was concerned that managers of foundations which owned large holdings in a business tended to be relatively unconcerned about producing income to be used in charitable activities, that their attention and interest would be devoted to the operation, maintenance, and improvement of the business while neglecting their charitable purposes, and that businesses owned by exempt organizations may be operated in a way that provides those businesses with a competitive advantage over businesses owned by taxable persons. In general, the Congress concluded that a private foundation should be limited in the amount of a business which it may control.

The Tax Reform Act of 1969, in effect, generally limited the combined ownership of a business corporation by a private foundation and disqualified persons (for this purpose, including certain related foundations) to not more than 20 percent of the voting stock.[32] (For example, if the disqualified person's holdings are five percent, the foundation itself may hold only 15 percent.) If persons other than disqualified persons have effective control of the corporation, the combined foundation/disqualified person holdings are limited to 35 percent. A private foundation may not conduct any business as a proprietorship.

Pursuant to a de minimis rule, there are no excess business holdings if a private foundation (together with related foundations) owns not more than two percent of the voting stock and not more than two percent of the value of all classes of stock, regardless of the extent of ownership by disqualified persons. Also, there are no percentage limitations on foundation ownership of a business which is functionally related to the foundation's charitable programs (within the meaning of sec. 4942(j)(4)), or of a business deriving at least 95 percent of its gross income from certain passive sources.

Under prior law, holdings in excess of permitted limits that are acquired after May 26, 1969 other than by purchase (e.g., by gift or bequest) must be disposed of by the foundation within five years

[32] If all disqualified persons together do not own more than 20 percent of the voting stock of a corporation, there is no limit on the nonvoting stock which may be held by the private foundation. To determine permitted holdings in a partnership, the foundation's "profits interest" is aggregated with the profits interests of all disqualified persons and substituted for the voting stock limitation applicable to corporations, and "capital interest" is used in place of nonvoting stock. In computing the holdings of any business enterprise, stock or other interests owned, directly or indirectly, by a corporation, partnership, estate, or trust are considered as owned proportionately by the beneficial owners.

after acquisition (sec. 4943(c)(6)). Post-May 26, 1969 purchases of stock by a foundation or a disqualified person which created or increased aggregate holdings beyond permitted limits did not qualify for the five-year grace period, and could immediately result in excise tax penalties on the foundation (subject to a 90-day grace period for a foundation to reduce its holdings as required after purchases by a disqualified person).

Grandfathered holdings

The 1969 Act provided special rules applicable where the business holdings of a private foundation (combined with the holdings of disqualified persons) exceeded the 20-percent/35-percent limitation on May 26, 1969. These special rules also apply to holdings acquired under trusts irrevocable on that date, or certain wills executed by that date, even though the actual transfer to the foundation occurs later. In general, grandfathered holdings are permitted to be retained, but are subject to gradual reduction over several phases.

Under the first phase, by the deadlines shown below the combined foundation/disqualified person holdings cannot exceed 50 percent of the voting stock of the corporation or, if less, 50 percent of the value of all outstanding shares—

Ownership on 5/26/69:	Deadline to reach 50% combined holdings:
More than 95% (under prior law, by the foundation alone)	May 26, 1989.
More than 75% combined holdings	May 26, 1984.
More than 50% combined holdings	May 26, 1979.

After expiration of the first phase, a second set of divestiture requirements becomes operational—

(1) If disqualified persons do not own more than two percent of the corporate voting stock at any time during the second phase (the 15 years after the close of the first phase), the combined foundation/disqualified person holdings must be reduced to not more than 35 percent by the end of that period (i.e., for a foundation which itself owned 95 percent of the stock on May 26, 1969, by May 26, 2004); and if at any time after the end of the second phase the holdings of disqualified persons exceed two percent, then the foundation itself cannot hold more than 25 percent of the voting stock.

(2) If the holdings of disqualified persons exceed two percent at any time during the second phase, then at all times thereafter the combined foundation/disqualified person holdings are limited to 50 percent, with no more than 25 percent of the voting stock being held by the foundation.

Grandfathered holdings are subject to reduction by operation of the "downward ratchet" rule. That rule, as in effect under prior law, provided that if there is any reduction in the holdings of a private foundation or in combined private foundation/disqualified person holdings, then these holdings can never go up again to the former grandfathered or otherwise permitted level over 20 percent (35 percent, if applicable).

Reasons for Change

After review of the general limitations on business holdings by foundations, the Congress concluded that the same reasons for which private foundations were prohibited, under the Tax Reform Act of 1969, from acquiring or owning substantial holdings of a business enterprise continued to be valid. The Congress continued to believe that the attention and energies of a private foundation and its managers should be directed toward performance of its charitable functions and not toward the operation of a business enterprise. The Congress believed that without such restrictions, the energies and resources of the private foundation could be directed toward operation of the business enterprise. Where the charitable ownership predominates, the business also may be run in a way which unfairly competes with other businesses. Moreover, ownership of significant interests in business enterprises makes the foundation provisions relating to self-dealing, minimum payout, and taxable expenditures difficult to administer.

In addition, the Congress concluded that the 1969 Act rules requiring phased divestiture of pre-1969 holdings by private foundations continued to be appropriate for several reasons. First, the same reasons for prohibiting private foundations from acquiring significant interests in business enterprises after 1969 apply to support requiring divestiture, over the transitional periods (up to 20 years) allowed under the 1969 Act, of large pre-1969 holdings. Second, in the 15 years since the enactment of the 1969 Act, many private foundations have divested themselves of their excess business holdings in reliance on the mandates of that statute. The Congress believed that to permit those private foundations which have failed to comply with the 1969 Act rules now to become exempt from divestiture would be unfair to those private foundations which properly relied on and complied with the law.

After reviewing the 1969 Act rules, the Congress also has concluded that certain modifications to those rules were desirable in order to carry out the overall intent of the 1969 Act.

First, the Congress believed that under prior law, the rules which require divestiture within five years of excess business holdings acquired (other than by purchase) by a private foundation after 1969 did not provide sufficient time to dispose of holdings which are exceptionally large or complex. Accordingly, the Act provides the Internal Revenue Service with discretionary authority to extend the normal five-year divestiture period for an additional five years in appropriate cases involving an unusually large gift or bequest of diverse or complex business holdings.

Second, the Congress believed that the operation of the "downward ratchet" rule under prior law was too harsh in certain situations. For example, since the enactment of the 1969 Act, it is now possible for a business enterprise to adopt an employee stock ownership plan (ESOP) to which the stock of the enterprise is contributed for the benefit of its employees. Often this stock is later redeemed from the ESOP as those employees terminate their employment. Under the downward ratchet rule, the private foundation's relative holdings decrease when the stock is transferred to the plan; as a result, when the stock is redeemed from the plan, the private foundation is forced to sell some of its otherwise permitted holdings to reduce its relative holdings to the new lower limit. The Congress believed that the downward ratchet rule should not apply where the reductions in the relative holdings of the private foundation result from new issuances of stock so long as the reduction is relatively minor. Accordingly, the Act provides a limited exception to the downward ratchet rule where the relative holdings of the private foundation are reduced by less than two percent by reason of issuances of stock (or stock issuances coupled with stock redemptions) and there are no changes in the number of shares held by the foundation.

The Congress also concluded that four modifications to the prior-law rules governing pre-1969 holdings were appropriate. First, under the 1969 Act divestiture rules for grandfathered holdings, the 10-year and 15-year periods for the first phase are determined by reference to the combined holdings of the private foundation and disqualified persons, while the 20-year period was determined by reference only to the holdings of the private foundation. The Congress did not find any persuasive reason for this different basis for measuring the length of the first phase. Accordingly, the Act provides that the 20-year period also is to be determined by reference to the combined holdings of the private foundation and disqualified persons on May 26, 1969.

Second, during the second and third phases of the divestiture rules for pre-1969 holdings, private foundations have a lower limit (i.e., 25 percent of voting stock) for direct holdings if disqualified persons own more than two percent of the business enterprise. Where disqualified persons first acquire more than two percent during those phases, prior law did not allow any period for the private foundation to reduce its holdings to the lower limit and avoid excise taxes. Accordingly, the Act provides that in such circumstances, the private foundation has five years to reduce its holdings to the lower limit.

Third, the Act provides that an employee stock ownership plan described in Code section 4975(e)(7) is excepted from the definition of disqualified persons, only for section 4943 purposes, with respect to grandfathered business holdings acquired pursuant to a pre-1969 will.

Fourth, the Act makes a technical amendment to the 1969 Act to allow the Herndon Foundation to continue to hold a majority interest in certain business holdings.

Explanation of Provisions

Disposition of certain post-1969 gifts or bequests (sec. 307 of the Act)

The Act gives the Internal Revenue Service discretionary authority to grant, in certain limited circumstances, one extension, for an additional five years, of the five-year divestiture period under section 4943(c)(6) for disposition of excess business holdings acquired by a private foundation after 1969 by gift or bequest. This provision applies only in the case of an unusually large gift or bequest of either diverse business holdings or holdings with complex corporate structures.

The extension authority is available only if (1) prior to the close of the initial five-year divestiture period allowed by section 4943(c)(6), the private foundation submits a plan to the Internal Revenue Service for disposition of all such business holdings, (2) prior to such date, the foundation also submits the disposition plan to the Attorney General (or other appropriate State official) having administrative or supervisory authority or responsibility with respect to the disposition, (3) the foundation submits to the Revenue Service any response to the disposition plan that it receives from such State official during the initial five-year period, and (4) the Revenue Service determines that the disposition plan can reasonably be expected to be carried out before the end of the extension period.[33] Further, the Revenue Service has authority to grant the extension only if the foundation establishes (1) that disposition within the initial five-year period has not been possible (except at a price substantially below fair market value) [34] by reason of (a) the unusually large size of the gift or bequest and (b) either the diversity of or the complex corporate structures involved in the business holdings, and (2) that the foundation has made diligent efforts to dispose of those business holdings within the initial five-year period.[35]

This provision of the Act applies to business holdings as to which the initial five-year period (sec. 4943(c)(6)) ends on or after November 1, 1983.

Exception to downward ratchet rule (sec. 308 of the Act)

The Act provides a limited exception to the downward ratchet rule under which a decrease in the percentage holdings of a private foundation in a business enterprise is disregarded, for purposes of the second sentence of section 4943(c)(4)(A)(ii), if (1) the decrease was attributable solely to issuances of stock (or to issuances of

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[33] Under a transitional rule in the Act, any plan for disposition submitted to the Revenue Service on or before the 60th day after the date of enactment of the Act (July 18, 1984) was treated as if submitted before the close of the initial five-year period.

[34] For purposes only of this provision in sec. 307 of the Act, a price which is at least five percent below fair market value is to be considered a price which is substantially below fair market value.

[35] The particular situation that gave rise to section 307 of the Act involves the John D. and Catherine R. MacArthur Foundation of Chicago. Section 307 of the Act is intended to give the Internal Revenue Service discretionary authority to grant an additional five-year divestiture period in cases where there has been an unusually large gift or bequest after 1969 of either diverse business holdings or holdings with complex corporate structures—as was the case with the MacArthur Foundation, where divestiture in the initial period was not possible because of the size and complexity or diversity of the holdings—and where the Internal Revenue Service also determines that the foundation can reasonably be expected to accomplish divestiture within the extended period. This provision was intended to apply to any interest in a business enterprise that constitutes an excess business holding subject to divestiture under Code section 4943(c)(6). In the particular situation involving the MacArthur Foundation, where one or more business enterprises owned by Bankers Life and Casualty Co. at the time of the bequest were distributed to the foundation as part of a plan intended to achieve overall divestiture of all excess business holdings within the required period, such enterprises are to be treated as excess business holdings which are eligible for the five-year additional divestiture period under the Act. This treatment is not to apply to any business enterprises acquired by purchase after the foundation received the bequest. *See* 130 Cong. Rec. H. 7113 (daily ed. June 27, 1984) (statement of Mr. Rostenkowski); 130 Cong. Rec. S. 8410 (daily ed. June 27, 1984) (statement of Sen. Dole).

stock coupled with subsequent redemptions of stock) in the business enterprise, (2) the net percentage decrease did not exceed two percent, and (3) the number of shares held by the private foundation is not affected by any such issuance of stock (or issuance coupled with redemptions of stock).[36]

If the exception applies, the limitations on the maximum permitted holdings of the private foundation and on the maximum permitted combined foundation/disqualified person holdings will not be reduced by the amount of the net decrease. If the net percentage decrease exceeds two percent, the exception does not apply and, as under prior law, the limitations on the maximum holdings of the private foundation will be permanently reduced by the amount of the decrease.

This amendment to the downward ratchet rule is effective for decreases and subsequent increases occurring after the date of enactment (July 18, 1984).

Eligibility for 20-year first phase (sec. 309 of the Act)

The Act modifies the divestiture rules enacted in the Tax Reform Act of 1969 to provide that the 20-year first phase period to reduce certain excess business holdings held on May 26, 1969 applies if the combined holdings of the private foundation and disqualified persons exceeded 95 percent on May 26, 1969, rather than only if the holdings of the foundation alone exceeded that amount. This amendment is effective as if it had been included in the 1969 Act.

Modification of second and third phases (sec. 310 of the Act)

The Act amends section 4943(c)(6) to provide, in effect, that if a private foundation's maximum holdings in a business enterprise must be reduced to 25 percent of the voting stock by reason of the acquisition by disqualified persons of more than two percent of the voting stock during either the second or third phase of the divestiture rules (i.e., where such acquisition would result in a substituted percentage holdings limitation under clause (i) or clause (ii) of sec. 4943(c)(4)(D)), the private foundation has a five-year period beginning on the date of such acquisition for disposition of the excess over 25 percent. This five-year period cannot be extended pursuant to the provision of the Act (sec. 307) relating to the divestiture period for certain post-1969 gifts or bequests. This amendment applies where such acquisitions by disqualified persons occur after the date of enactment (July 18, 1984).

Exclusion of ESOP from disqualified person definition for grandfathered business holding rules (sec. 314(c) of the Act)

Under the Act, an employee stock ownership plan described in Code section 4975(e)(7) is excluded from the definition of disqualified person (sec. 4946(a)), only for purposes of section 4943, with respect to grandfathered business holdings described in section 4943(c)(4) and (5), that is, holdings acquired pursuant to certain wills executed before May 27, 1969 or trusts which were irrevocable

[36] For purposes of this provision in section 308 of the Act, an increase in the number of shares held by the foundation which results solely from a stock split applicable to all holders of the same class of stock is to be disregarded.

on May 26, 1969. This provision is effective for taxable years beginning after the date of enactment (July 18, 1984).

Technical amendment in description of Herndon Foundation (sec. 314(b) of the Act)

The Act makes a technical amendment to clarify that the Herndon Foundation is permitted to continue to hold a majority of the stock of certain business enterprises. This amendment applies as if it had been included in section 101(l)(4) of the Tax Reform Act of 1969.

I. Exemption for Certain Games of Chance (sec. 311 of the Act and Code sec. 513)

Prior Law

Organizations that are exempt from Federal income taxation are subject to tax on income derived from an unrelated trade or business (secs. 511-514). The term unrelated trade or business generally means any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of the activities for which the organization was granted tax exemption. An exception to the definition of an unrelated trade or business is provided for certain bingo games conducted by tax-exempt organizations (sec. 513(f)).

Reasons for Change

The Congress believed that, under certain limited circumstances, tax-exempt organizations should not be subject to the tax on unrelated business taxable income on income from games of chance which, under a State law in effect as of October 5, 1983, may legally be conducted only by nonprofit organizations.

Explanation of Provision

The Act provides that, for purposes of section 513, the term unrelated trade or business does not include any trade or business that consists of conducting a game of chance if (1) the game of chance is conducted by a nonprofit organization, (2) the conducting of the game by such organization does not violate any State or local law, and (3) as of October 5, 1983, there was a State law in effect that permitted the conducting of the game of chance only by a nonprofit organization (i.e., the conducting of the game of chance by other than nonprofit organizations would violate the State law).

Effective Date

The provision applies retroactively to games of chance conducted after June 30, 1981, in taxable years ending after that date.

J. Exception to Self-Dealing Rules for Certain Stock Transactions (sec. 312 of the Act and Code sec. 4941)

Prior Law

The Tax Reform Act of 1969 in effect prohibited certain transactions between a private foundation and disqualified persons (including substantial contributors), and imposed excise taxes for violations of these rules. The transactions prohibited as "self-dealing" generally include (1) the sale, exchange, or leasing of property between a private foundation and a disqualified person and (2) the lending of money or other extension of credit between a private foundation and a disqualified person (sec. 4941).

Reasons for Change

Pursuant to Code section 507(d) as in effect under prior law, once a donor to a private foundation was treated as a substantial contributor and hence as a disqualified person, that person retained status as a disqualified person forever, regardless of whether the relative value of the donor's contributions significantly diminished over time by reason of another substantial contribution to the foundation. As indicated in the description below of section 313 of the Act, the Congress believed that this rule should be changed so that the disqualified person status of a person whose relative contributions have become insignificant, and who has no other involvement with the foundation, will terminate in appropriate cases.

In general, the Congress believed that this change should apply prospectively. However, it was understood that the rule that substantial contributors retain forever their status as disqualified persons has resulted in the application of the self-dealing rules in a case involving the sale of publicly traded stock of Murphy Motor Freight Lines, Inc. (the "Company") by the Wasie Foundation to the Company. In that case, the Company was treated as a disqualified person solely because of contributions of less than $10,000 early in the life of the Wasie Foundation. As a result, the later sale of stock by the Wasie Foundation to the Company pursuant to the settlement of litigation involving the control of the Company was treated as an act of self-dealing. The Congress believed that the Company, under the unusual facts involved, should not be subject to section 4941 taxes merely because of its earlier contribution so long as the total consideration paid to the Wasie Foundation (i.e., the amount of any cash and the fair market value of any notes received for the stock by the Wasie Foundation in connection with such purchase) was equal to or exceeded the value of the stock at the time of the sale.

Explanation of Provision

The Act provides that Code section 4941 is not to apply to the purchase during 1978 of stock from a private foundation (and to any note issued in connection with such purchase) if (1) consideration for the purchase equaled or exceeded the fair market value of the stock at the time of the sale; (2) the purchaser of the stock did not make any contribution to the foundation at any time during the five-year period ending on the date of the purchase; (3) the aggregate contributions to the foundation by the purchaser before such date were both less than $10,000 and also less than two percent of the total contributions received by the foundation as of that date; and (4) the purchase was pursuant to the settlement of litigation involving the purchaser. That is, under the Act, Code section 4941 is not to apply in the case of the 1978 sale of stock of Murphy Motor Freight Lines, Inc. by the Wasie Foundation to Murphy Motor Freight Lines, Inc. and the related financing by the Wasie Foundation provided that the total consideration received (i.e., the sum of the cash and the value of the notes) equaled or exceeded the fair market value of the stock at the time of the sale.

Effective Date

The provision is effective on enactment and applies retroactively to the 1978 transactions described above. In addition, the Act provides that if credit or refund of any overpayment of section 4941 taxes resulting from the provisions of section 312(a) of the Act is precluded prior to close of the one-year period beginning on the date of enactment (July 18, 1984) by the operation of any law or rule of law, a refund or credit of such section 4941 taxes previously paid with respect to such 1978 transactions may be made or allowed if a claim for refund or credit is filed before the close of such one-year period.

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K. Termination of Status as Substantial Contributor (sec. 313 of the Act and Code sec. 507(d))

Prior Law

Under the tax law, status as a disqualified person is relevant for several private foundation provisions, including the prohibitions on self-dealing between a disqualified person and the foundation and on excess business holdings. The term disqualified person generally includes substantial contributors, foundation officers, directors, or trustees, and members of the family of such individuals, plus certain other related entities (sec. 4946).

The term substantial contributor means a person whose contributions to the foundation exceeded two percent of all contributions received by the foundation before the close of the year in which the contribution is made, but only if the person's contributions exceed $5,000 (sec. 507(d)(2)). Under prior law, once a person became a substantial contributor, that person retained such status forever.

Reasons for Change

The Congress believed that the prior-law rule under which a person who once falls into the category of substantial contributor retains such status forever, regardless of subsequent facts concerning the person's diminishing relationship to and lack of involvement with the foundation, was unnecessarily restrictive and could lead to unintended harsh consequences in certain limited circumstances. The Congress concluded that a substantial contributor may sufficiently terminate any control over or connection with the foundation, so that the contributor no longer should be treated as a disqualified person, if there has been a sufficiently long time since that person had made any contribution to or had any relationship with the foundation, and if there have been much larger contributions to the foundation from one other person.

Explanation of Provision

The Act provides that a substantial contributor will cease to be treated as such if, as of the close of a taxable year of the private foundation, each of three requirements is satisfied.

First, neither the substantial contributor nor any related person[37] made a contribution to the foundation at any time within the 10-year period ending at the close of the taxable year. Second, neither the substantial contributor nor any related person was a foundation manager of the private foundation during the 10-year

[37] For purposes of sec. 313 of the Act, the term related person means any other person who would be a disqualified person (within the meaning of sec. 4946) by reason of the person's relationship to the substantial contributor. In the case of a substantial contributor which is a corporation, the term related person also includes any officer or director of the corporation.

period. Third, the aggregate contributions (adjusted for appreciation on such contributions while held by the foundation) made by the substantial contributor and all related persons are determined by the Internal Revenue Service to be insignificant when compared to the aggregate amount of contributions to that foundation by one other person.[38] The Congress intended that the amount of contributions from the substantial contributor and all related persons are to be treated as insignificant for this purpose if in the aggregate such contributions (adjusted for appreciation) equal less than one percent of the contributions by the other person.

If a substantial contributor to a foundation ceases to be treated as such under this provision, then at the same time as such termination of status occurs, another person who constitutes a disqualified person with respect to the foundation solely by virtue of the person's relationship (e.g., as a family member) to the substantial contributor also ceases to be treated as a disqualified person.

Effective Date

The amendment made by section 313 of the Act applies to taxable years beginning after December 31, 1984.

[38] For example, a gift of $250,000 in cash in 1969 would be considered insignificant in comparison to a gift of $100 million made by another person in 1979. Similarly, a gift of $250,000 of stock in 1969 would be considered insignificant in comparison to a gift of $107 million in 1979, even assuming the value of stock (originally worth $250,000 when made) had appreciated in value to $1.2 million as of the date on which the $107 million gift was made. However, a gift of $250,000 of stock in 1969 which had appreciated in value to $15 million would not be considered insignificant in comparison to another person's gift of $107 million in 1979.

L. Review of Treasury Regulations on Expenditure Responsibility (Code sec. 4945)

Present Law

In the case of grants to organizations other than public charities, a private foundation must exercise "expenditure responsibility" over the grant (sec. 4945(d)). To ensure that such grants will be properly used by the recipient for charitable purposes, the grantor must make reasonable efforts, and establish adequate procedures, to see that the grant is spent solely for proper uses, to obtain full reports from the grantee, and to make full reports to the Internal Revenue Service on the grants.

Treasury regulations expressly state that the expenditure responsibility rules do not make a donor foundation the insurer or guarantor of the activities of donee organizations, and set forth guidelines under which donor foundations may satisfy the section 4945 rules (Reg. sec. 53.4945-5(b)). For example, the regulations state that a private foundation considering a grant request should conduct a limited inquiry concerning the potential donee which is complete enough to give a reasonable person assurance that the grant would be used for charitable purposes. The scope of the inquiry would vary with factors such as the dollar amount of the grant. No such pre-grant inquiry would be required if the donee organization had received prior grants from the donor foundation and had submitted to the donor the required reports substantiating proper use of the earlier grant funds.

The donor foundation must obtain a written commitment from the donee foundation that the latter will use the grant funds solely for charitable purposes and will submit reports as to whether the funds have been used in compliance with the grant terms. The grantor foundation need not conduct any independent verification of such reports unless it has reason to doubt their accuracy or reliability (Reg. sec. 53.4945-5(c)(1)). In meeting its own reporting requirements to the Internal Revenue Service, the grantor foundation may rely on statements from the donee organization or other records showing the information which the grantor, in turn, must report to the Revenue Service (Reg. sec. 53.4945-5(c)(4)).

Reasons for Action

During consideration of the Act, the Congress reaffirmed the central purpose of the expenditure responsibility rules—to ensure that foundation grants will be properly used by the recipient organization solely for charitable purposes and activities, and not for other purposes such as funding political or legislative activities. The Congress believed that a donor private foundation, whose favorable tax treatment derives from the absolute dedication of its assets to charitable purposes, should not be able to disavow responsibility for use of tax-deductible contributed funds and the tax-exempt earnings thereon simply by handing over money to another organization. Indeed, the Congress believed that even independent of any tax law requirements, foundations making grants would want to make reasonable efforts, and establish adequate procedures, to see that the grant is spent solely for proper uses and to obtain full reports from the grantee. At the same time, the Congress was concerned whether the implementation in Treasury regulations of the section 4945(d) statutory requirements may have been unduly burdensome or unnecessary in some respects, and therefore could possibly operate to deter grants by some foundations to newly formed, community-based organizations.

Action

The Congress directed the Treasury Department to review its expenditure responsibility regulations for purposes of modifying requirements which are found to be unduly burdensome or unnecessary. As part of its review, Treasury is to modify rules relating to the required grantor reports to the Internal Revenue Service. The Treasury Department is to report to the tax-writing committees on its review and modifications.

M. Review of Treasury Regulations Concerning Reliance on Internal Revenue Service Classifications

Present Law

Private foundations must exercise expenditure responsibility with respect to grants made to organizations other than public charities (sec. 4945(d)). In addition, distributions to a private nonoperating foundation generally may not be used to satisfy the grantor foundation's minimum distribution requirements (sec. 4942). Therefore, in order to avoid violations of the expenditure responsibility and minimum distribution rules, a private foundation must determine whether a potential donee is a public charity, a private operating foundation, or a private nonoperating foundation.

The Internal Revenue Service issues determination letters to section 501(c)(3) organizations relating to their status as public charities or private foundations. In many cases, the public charity status of a donee is determined by the percentage of its support that is received from the general public. For new section 501(c)(3) organizations which do not have four years of support history, determinations of public charity status may be issued if the organization can reasonably be expected to meet the public support test during an advance ruling period of either two or five years.

In general, a donor is permitted to rely on a determination by the Internal Revenue Service of a donee's public charity status until publication of notice of a change of status. However, a donor foundation may not rely on the donee organization's classification if the donor foundation is responsible for or aware of a substantial and material change in the donee organization's sources of support that results in the organization's loss of classification as a publicly supported organization. In general, the donor foundation will not be considered responsible for or aware of such a change in support (and hence may rely on a published classification) if the grant is made in reliance on a detailed written statement by the grantee organization that the grant will not result in loss of public charity status, and the information in such statement would not give rise to a reasonable doubt as to the effect of the grant (Treas. Reg. sec. 1.509(a)-(3)(c)).

To facilitate reliance on published classifications, the Internal Revenue Service has issued guidelines specifying circumstances under which a donor foundation will not be considered responsible for a substantial and material change in support of the donee organization.[39] In addition, the Revenue Service has published guide-

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[39] Under these guidelines, a donor organization generally will not be considered responsible for a substantial and material change in support if the total of gifts, grants, and contributions received from the donor organization for a taxable year does not exceed 25 percent of the aggregate support received by the donee organization from all other sources for the four taxable years

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lines specifying circumstances under which a grant will be considered "unusual" and hence will not cause the donee organization to lose its status as publicly supported.[40]

Reasons for Action

The Congress believed that in general it is appropriate, in order to implement the expenditure responsibility and minimum distribution rules, to require a donor private foundation to take reasonable steps to determine whether its grant will cause the donee to lose public charity status. Where the donor foundation's grant itself causes the donee organization to lose the characteristics of a public charity, then it is generally appropriate to require the donor foundation to observe the rules applicable to grants made to other private foundations (e.g., to take reasonable steps to see that the grant funds are used by the donee foundation solely for charitable purposes). Also, the Congress believed that the Internal Revenue Service guidelines issued in 1981 had substantially facilitated reliance by donor foundations on published determinations of the status of donees, and hence had minimized possibilities that a donor foundation could inadvertently become subject to excise tax liability because of lack of knowledge about the donee's status. At the same time, the Congress was concerned that some private foundations may hesitate to make grants to newly formed organizations which may have little support from the general public in the first two or three years of their existence, because it is difficult for the foundation to obtain absolute assurance that the grant will not cause the organization to fail to qualify for public charity status.

Action

The Congress directed the Treasury Department to extend to five years the advance ruling period during which qualifying newly formed organizations are considered public charities, and to modify its regulations to permit greater reliance on Internal Revenue Service classifications concerning newly formed organizations in the first five years of their existence.

N. Revenue Effect

The provisions relating to charitable contributions to private nonoperating foundations (sec. 301 of the Act) is estimated to reduce fiscal year budget receipts by $10 million in 1985, $17 mil-

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immediately preceding the year of the grant (Rev. Proc. 81-6, 1981-1 C.B. 620). In such circumstances, the donor foundation can rely on the classification of the donee organization as publicly supported without risk that its grant will later be treated as causing the donee organization to lose its public charity status (thereby subjecting the donor foundation to excise tax penalties for failure to exercise expenditure responsibility).

[40] Under these guidelines, a grant generally will be considered unusual if six conditions are met: (1) the grant is not made by a donor foundation which created the donee organization or was a substantial contributor to the donee organization; (2) the grant is not made by a donor organization which is in a position of authority with respect to the donee organization; (3) the grant is made in cash, readily marketable securities, or assets that directly further the exempt purpose of the donee organization; (4) the donee organization has received an advance or final ruling that it is classified as a publicly supported organization; (5) there are no material restrictions imposed on the grant; and (6) if the grant is intended to pay for the operating expenses of the donee organization, the grant is expressly limited to one year's operating expenses (Rev. Proc. 81-7, 1981-1 C.B. 621).

lion in 1986, $18 million in 1987, $21 million in 1988, and $24 million in 1989.

The provision relating to exemption for certain games of chance (sec. 311 of the Act) is estimated to reduce budget receipts by less than $1 million annually.

The other provisions of title III of the Act are estimated to reduce budget receipts by $23 million in fiscal year 1985, and by $29 million in each of fiscal years 1986, 1987, 1988, and 1989.

In the aggregate, the provisions of title III of the Act are estimated to reduce fiscal year budget receipts by $33 million in 1985, $46 million in 1986, $47 million in 1987, $50 million in 1988, and $53 million in 1989.

TITLE IV—TAX SIMPLIFICATION PROVISIONS

A. Individual Estimated Tax

(Secs. 411-414 of the Act, sec. 6654 of the Code, and Revenue Ruling 83-111)[1]

Prior Law

Under prior law, an individual who failed to pay an installment of estimated income tax on or before the due date generally was subject to a penalty at the rate established for interest (under sec. 6621). The penalty could not be waived. The penalty was computed by applying the interest rate to the amount of the underpayment of the installment for the period of the underpayment. The amount of the underpayment was the difference between the payments (including withholding) made on or before the due date of each installment and 80 percent of the total tax shown on the return for the year, divided by the number of installments that should have been made. Estimated tax payments of the alternative minimum tax were not required.

There were four exceptions to the general underpayment penalty. No penalty was imposed upon a taxpayer if total tax payments for the year (withholding plus estimated tax payments) equal or exceed 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 percent of the taxes which would be due if the income already received during the current year were placed on annual basis; (3) 90 percent 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. Also, no penalty was imposed where the tax (reduced by withholding) is less than a minimal amount ($300 in 1983, $400 in 1984, and $500 in 1985 and thereafter), or where there was no tax liability for the preceding taxable year.

Reasons for Change

The Congress believes that generally taxpayers who pay their tax by making estimated tax payments should, to the extent possible, be treated no more favorably than those who pay their tax primarily through wage withholding. While the present rules governing the estimated tax work well in most cases, there are technical

[1] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, secs. 411-414; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1488-1493; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 186; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 506-507; and H. Rep. No. 98-861 (June 23, 1984), pp. 1115-1116 (Conference Report).

problems and inequities that should be corrected. First, the Congress is concerned that the Commissioner of Internal Revenue cannot waive the penalty for failure to make estimated tax payment even where the failure is due to extreme hardship. While the Congress recognizes that the system cannot be administered if waivers are readily available, the Commissioner should have the authority to grant a waiver in limited extreme hardship cases. Therefore, the Act authorizes the Internal Revenue Service to waive the penalty in certain limited circumstances.

In addition, the prior law exceptions to the penalty, on the one hand, may have allowed individuals to improperly avoid estimated tax requirements in some circumstances, while subjecting other individuals to a substantial penalty for failure to meet one of the exceptions by a few dollars. The exceptions are therefore restructured to avoid these results. Finally, the Congress believes that persons subject to the alternative minimum tax, as restructured under TEFRA, should be required to make current estimated payments just as individuals subject to other income taxes are required to do.

Explanation of Provision

Estimated income tax for individuals

The Act makes a number of modifications to the prior law requirements and consolidates all the rules into one section of the Code. Under the Act, the underpayment penalty with respect to any installment will apply to the difference between payments made by the due date of the installment and the lesser of an installment based on 80 percent of the tax shown on the return or 100 percent of the tax shown on the preceding year's return, if a return was filed for the preceding year. In addition, a penalty will be imposed with respect to any payment only to the extent the total payments for the year up to the required installment are below 80 percent of the taxes which would be due if the income already received during the current year was placed on an annualized basis.[2] The exceptions from the penalty described in paragraphs (3) and (4) of prior law (above) are repealed. Estimated tax payments for the alternative minimum tax will be required.[3]

The Internal Revenue Service can waive the penalty if the failure to make a payment was due to casualty, disaster, or other unusual circumstances where it would be inequitable to impose the penalty. Thus, for example, this waiver could be granted where the taxpayer's books and records were destroyed by fire or other casualty, or where payment was not made because of the death or serious illness of the taxpayer. Also, the penalty can be waived where it would be inequitable to impose a penalty, for example, because the taxpayer substantially overstated his or her tax liability shown on the return. In addition the underpayment penalty may be waived for reasonable cause for either of the first 2 years after (1) the taxpayer retires upon reaching age 62 or (2) becomes disabled.

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[2] Subsequent installments must be adjusted to recapture any reduction resulting from the application of this rule.

[3] The Act inadvertently deleted the rule (old section 6073) that certain non-resident aliens were not required to make their first payment before June 15. It is anticipated that a technical correction retaining the June 15 date will be made.

If the taxpayer designates that the overpayment of tax shown on his return is to be credited against his estimated tax, but the overpayment is offset for either past-due child support or non-tax Federal debt under section 6402 (c) or (d), and the taxpayer is not notified of the offset prior to the due date of the estimated tax, the Congress intends that the Secretary consider these circumstances as warranting a waiver of the estimated tax penalty.

Credit of tax overpayments

The Act also provides that the rules relating to the crediting of an income tax (individual or corporate) overpayment against an estimated tax liability shall be determined without regard to Revenue Ruling 83-111.[4] That ruling held that where a taxpayer with an overpayment of tax from a prior year files a timely return pursuant to an extension of time to file, the crediting of the overpayment to the current year's estimated tax liability may not be made prior to the date the return is filed and the taxpayer so elects. Under the Act, it is intended that the taxpayer may elect to credit the overpayment to an estimated tax payment arising after the overpayment arose but before the election is made. Where the credit is made to an estimated tax payment arising prior to the election, interest on any overpayment will not be payable [5] and interest on any underpayment which arises because of a deficiency in tax for the prior year will run from the date the credit is effective.

Thus, for example, assume a taxpayer makes estimated tax payments (including withholding) of $10,000 in 1984 and receives an extension of time to file the 1984 return until August 15, 1985. Also assume that a return is filed on August 15, 1985, showing a liability of $8,000 for 1984. The taxpayer may elect to credit the $2,000 overpayment to the April 15 estimated tax payment of his or her 1985 tax. Interest on the $2,000 overpayment will not be payable. If it is later determined that the taxpayer's liability for 1984 was actually $11,000, interest on an underpayment of $3,000 will begin to run on April 15, 1985.

Effective Date

The provisions are generally effective for taxable years beginning after December 31, 1984. The provision relating to waiver of penalties is effective for taxable years beginning after December 31, 1983. In addition, the provision relating to Revenue Ruling 83-111 is effective January 1, 1984.

Revenue Effect

These provisions are estimated to increase revenues by $746 million in fiscal year 1985, and to reduce revenues by $6 million in fiscal year 1986, $9 million in fiscal year 1987, $15 million in fiscal year 1988 and $21 million in fiscal year 1989.

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[4] I.R.B. 1983-31, p. 6. This ruling was revoked by Rev. Rul. 84-58, I.R.B. 1984-16, p. 6.
[5] Treas. reg. section 301.6611-1(h)(2)(vii).

B. Domestic Relations

1. Treatment of Transfer of Property Between Spouses or Incident to Divorce (sec. 421 of the Act and sec. 1041 of the Code)[6]

Prior Law

The Supreme Court had ruled that a transfer of appreciated property to a spouse (or former spouse) in exchange for the release of marital claims resulted in the recognition of gain to the transferor *(United States* v. *Davis* (370 U.S. 65 (1962)). The spouse receiving the property received a basis in the asset transferred equal to its fair market value. These rules did not apply in the case of the equal division of community property, and the IRS had ruled that this rule did not apply to the partition of jointly held property.[7] The tax treatment of divisions of property between spouses involving other various types of ownership under the different State laws was often unclear and had resulted in much litigation.[8] Several states had amended their property law in an attempt to avoid the result in the *Davis* case.

In addition, under prior law, losses were not allowed with respect to the transfer of property between spouses (sec. 267), and capital gains treatment and installment sales reporting were not allowed on the sale or exchange of depreciable property between spouses (secs. 1239 and 453(g)). These limitations did not apply to transfers of property between former spouses.

Reasons for Change

The Congress believes that, in general, it is inappropriate to tax transfers between spouses. This policy is already reflected in the Code rule that exempts marital gifts from the gift tax, and reflects the fact that a husband and wife are a single economic unit.

The current rules governing transfers of property between spouses or former spouses incident to divorce have not worked well and have led to much controversy and litigation. Often the rules have proved a trap for the unwary as, for example, where the parties view property acquired during marriage (even though held in one spouse's name) as jointly owned, only to find that the equal division of the property upon divorce triggers recognition of gain.

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[6] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 422; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1491-1493; and H. Rep. No. 98-861 (June 23, 1984), pp. 1116 (Conference Report).

[7] See Rev. Rul. 74-347, 1974-2 C.B.26

[8] See e.g., *Commissioner* v. *Collins*, 412 F.2d 211 (10th Cir. 1969) *U.S.* v. *Wallace*, 439 F. 2d 757 (8th Cir. 1971); *Commissioner* v. *Wiles*, 499 F.2d 255 (10th Cir. 1974); *U.S.* v. *Imel*, 523 F.2d 853 (10th Cir. 1975); *W. W. McKinney*, 64 T.C. 262 (1975); *U.S.* v. *Bosch*, 590 F.2d 165 (5th Cir. 1979).

Furthermore, in divorce cases, the government often gets whipsawed. The transferor will not report any gain on the transfer, while the recipient spouse, when he or she sells, is entitled under the *Davis* rule to compute his or her gain or loss by reference to a basis equal to the fair market value of the property at the time received.

The Congress believes that to correct these problems, and make the tax laws as unintrusive as possible with respect to relations between spouses, the tax laws governing transfers between spouses and former spouses should be changed.

Explanation of Provision

The Act provides that the transfer of property to a spouse incident to a divorce [9] will be treated, for income tax purposes, in the same manner as a gift. Gain (including recapture income) or loss will not be recognized to the transferor, and the transferee will receive the property at the transferor's basis (whether the property has appreciated or depreciated in value). Because any transfer of property, including money, is treated as if made by (and acquired by) gift, the recapture rules of sections 1245, 1250, 1254, etc. will not apply, and the limitation on amortizing certain term interests under section 273 will apply.

A transfer will be treated as incident to a divorce if the transfer occurs within one year after the parties cease to be married or is related to the divorce. This nonrecognition rule applies whether the transfer is for the relinquishment of marital rights, for cash or other property, for the assumption of liabilities in excess of basis,[10] or for other consideration and is intended to apply to any indebtedness which is discharged. Thus, uniform Federal income tax consequences will apply to these transfers notwithstanding that the property may be subject to differing state property laws.

In addition, this nonrecognition rule applies in the case of transfers of property between spouses during marriage (except where the transferee spouse is a non-resident alien).

Where an annuity is transferred, or a beneficial interest in a trust is transferred or created, incident to divorce or separation, the transferee will be entitled to the usual annuity treatment, including recovery of the transferor's investment in the contract (under sec. 72), or the usual treatment as the beneficiary of a trust (by reason of sec. 682), notwithstanding that the annuity payments or payments by the trust qualify as alimony or otherwise discharge a support obligation.[11] The transfer of a life insurance contract to a spouse incident to a divorce or separation generally will no longer result in the proceeds of the policy later being includible in income, since the policy will have a carryover basis and therefore the transfer for value rules (sec. 101(a)(2)) will not apply. Also, the transfer of an installment obligation will not trigger gain and the

[9] For purposes of this provision, an annulment is to be treated as a divorce.

[10] It is intended that no gain is to be recognized on the transfer of property for the assumption of (or subject to) liabilities in excess of basis only if the spouse (and not a trust) owns the property after the transfer is made.

[11] This rule relates, in part, to amendments made to Code section 71 by section 422 of the Act.

transfer of investment credit property will not result in recapture if the property continues to be used in the trade or business.[12]

Effective Date

The provision applies (1) to transfers after July 18, 1984, and (2) to transfer after December 31, 1983, and on or before July 18, 1984, if both parties elect. However, it will not apply to transfers after July 18, 1984, pursuant to instruments in effect before that date unless both parties elect to have the provision apply.

Revenue Effect

This provision will reduce revenues by less than $5 million annually.

[12] See also Treasury Temporary regulations sec. 1.1041-IT for rules relating to transfer of property between spouses or incident to divorce.

2. Alimony (sec. 422 of the Act and secs. 71 and 215 of the Code)[13]

Prior Law

In general

Under prior law, payments of alimony pursuant to a decree of divorce or separate maintenance, a written separation agreement or decree for support or maintenance were deductible by the payor spouse and includible in the income of the recipient spouse. The amount of the payment was deductible in computing adjusted gross income and thus was allowable whether or not the payor itemizes his or her deductions.

In order to be treated as alimony, a payment must have met several requirements. First, the payment must have been in discharge of a legal obligation imposed upon or incurred by a spouse because of a family or marital relationship. Second, the payment must have been imposed under the decree of divorce or separate maintenance or under a written instrument incident to the divorce or separation, made under a written separation agreement, or required under a decree of support or maintenance. Third, the payment must have been "periodic." A payment would not have qualified as "periodic" if it discharged a principal sum, unless the sum could have been paid over a period exceeding 10 years from the date of the divorce or separation decree, instrument or agreement; then the annual amount treated as alimony could not have exceeded 10 percent of the principal sum. A contingent payment was not a payment in discharge of a principal sum.

Payments which were fixed by the decree or agreement as child support were not treated as alimony and therefore were not deductible by the payor or includible in income of the recipient.[14]

Legislative background

Prior to 1942, there was no statutory provision explicitly dealing with alimony payments. In 1917, the Supreme Court held that, under the provisions of the Income Tax Act of 1913, alimony paid to a divorced wife was not taxable income.[15] From 1917 to 1942, the result in the *Gould* case remained unchanged and alimony was neither includible in the recipient's income nor deductible by the payor.

When tax rates were increased significantly in 1942, Congress recognized that the higher tax rates would intensify the hardship

[13] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 423; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1194-1197; and H. Rep. No. 98-861 (June 23, 1984), pp. 1116-1118 (Conference Report).

[14] *Commissioner* v. *Lester*, 366 U.S. 299 (1961) sets forth rules relating to the designation of amounts as child support rather than alimony.

[15] *Gould* v. *Gould*, 245 U.S. 151 (1917).

of payment of alimony out of after-tax income. Congress, therefore, enacted provisions in the Revenue Act of 1942 to require that certain alimony payments be included in the recipient spouse's income and to permit the payor spouse to deduct those payments as an itemized deduction. These provisions applied to alimony payments made by persons who were divorced or legally separated. In 1954, the alimony provisions were extended to apply to payments made under a decree for support where the parties are physically separated. The Tax Reform Act of 1976 permitted alimony to be deducted in arriving at adjusted gross income so that a taxpayer who does not itemize deductions may nevertheless deduct alimony.

Tax effects

A principal purpose for the present tax treatment of alimony is to relieve the payor of the burden of paying tax on the income which is transferred to the payee spouse as alimony and to impose that burden on the spouse receiving the alimony. In addition to transferring the tax burden, under prior law an overall tax savings generally results because the payor is normally in a higher marginal tax bracket than the payee. Because rates for a single taxpayer or head of household are lower than the rates for married persons filing separate returns (upon which the joint return rates are based), two individuals who are divorced and between whom alimony is paid may pay less total tax than they paid prior to marriage or during marriage.

For example, assume that single individuals A and B have earned income of $51,000 and $11,000 (taxable income of $50,000 and $10,000), respectively. As single taxpayers, their respective taxes for 1984 would be $13,889 and $1,075. Their combined tax is $14,964. If A and B were married for 1983, their joint return tax liability would be $14,750.[16] If A and B are divorced for 1984 and A pays B $20,000 alimony, they each would have a liability as a single taxpayer of $6,113. Their combined tax would be $12,226.

Reasons for Change

The Congress believes that the prior law definition of alimony is not sufficiently objective. Differences in State laws create differences in Federal tax consequences and administrative difficulties for the IRS. The Congress believes that a uniform Federal standard should be set forth to determine what constitutes alimony for Federal tax purposes. This will make it easier for the Internal Revenue Service, the parties to a divorce, and the courts to apply the rules to the facts in any particular case and should lead to less litigation. The Act attempts to define alimony in a way that would conform to general notions of what type of payments constitute alimony as distinguished from property settlements and to prevent the deduction of large, one-time lump-sum property settlements.

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[16] This is based on $58,900 taxable income ($62,000 gross income, $1,100 marriage penalty deduction (under sec. 221) and a $2,000 deduction for personal exemptions). This example assumes neither party itemizes deductions.

Explanation of Provision

Under the Act, alimony payments will continue to be deductible by the payor spouse and includible in income by the recipient spouse.[17] However, the Act amends the definition of alimony. The requirement that the payment must be made on account of a marital obligation imposed under local law is repealed and the prior law requirement that the payment be "periodic" is not retained.

Under the Act, an alimony payment must meet several requirements. The payment must be made in cash and be received by, or on behalf of, the payor spouse (or former spouse). A payment can also qualify as alimony, for example, where a cash payment is made to a third party for the benefit of the payee spouse. As under prior law, an alimony payment must be made under a decree of divorce or separate maintenance or under a written instrument incident to the divorce, a written separation agreement, or a decree requiring support or maintenance payments.

Where the parties are divorced or legally separated, they may not be members of the same household at the time the payment is made. The parties are not to be treated as members of the same household where the taxpayer is preparing to shortly depart from the household of the other spouse.

In order to prevent the deduction of amounts which are in effect transfers of property unrelated to the support needs of the recipient, the Act provides that a payment qualifies as alimony only if the payor (or any person making a payment on behalf of the payor) has no liability to make any such payment for any period following the death of the payee spouse. The divorce or separation instrument itself must state that there is no such liability. A provision for a substitute payment, such as an additional amount to be paid as child support after the death of the payee spouse will prevent a corresponding amount of the payment to the payee spouse from qualifying as alimony. Amounts payable under a life insurance contract on the life of the payee spouse will not be treated as a liability which would affect the status of other payments made by the payor spouse.

The parties, by clearly designating in a written agreement, can provide that otherwise qualifying payments will not be treated as alimony for Federal income tax purposes and therefore will not be deductible or includible in income.

As under prior law, amounts fixed as child support will not be treated as alimony. Under the Act, if any amount specified in the instrument will be reduced on the happening of a contingency relating to a child, then an equal amount will be treated as child support rather than alimony. Thus, for example, if the divorce instrument provides that payments will be reduced by $100 per month when a child reaches age 18 (or in the month the child happens to reach that age), then $100 of each monthly payment will be treated as fixed for child support.

The Act provides that the Internal Revenue Service may require the payor spouse to furnish on his or her tax return the name and

[17] The Act retains the prior law rules concerning the ability of a deceased spouse's estate to deduct alimony payments.

social security number of the payee spouse, and that the payee must furnish that number to the payor. A $50 penalty is imposed against any party for failure to comply with the applicable requirement unless the failure is due to reasonable cause and not to willful neglect.

The Act generally provides that deductible alimony payments (in excess of $10,000 per year) must continue for at least 6 years duration. Specifically, the Act provides that any payment in excess of $10,000 per year will be deductible only if the instrument provides that the payor spouse is to make alimony payments for at least 6 consecutive calendar years beginning with the year a payment is first made (on the assumption that neither spouse dies during that period and that the payee does not remarry). The first $10,000 paid in any year will not be disallowed by this rule.

Also, if payments are deductible for any year, but in a subsequent year (during the 6-year period) the payments decrease by more than $10,000 from that prior year, then those excess payments (i.e., those earlier year payments in excess of the sum of the later year payments plus $10,000) will be includible in the income of the payor and deductible by the payee in the subsequent year. Thus, for example, if alimony payments of $25,000 are made in year 1 and payments of $12,000 are made in year 2, then $3,000 will be recaptured in year 2. If the payments further decline to $1,000 in year 3, then, in year 3, an additional $11,000 will be recaptured from year 1 and $1,000 will be recaptured from year 2. If, prior to the end of year 6, payments further decline, additional recapture will occur. In applying these rules, years beginning with the year of death of either spouse or remarriage of the payee spouse will be ignored if payments terminate by reason thereof. Also, for purposes of applying these rules, payments pursuant to a support decree not incident to divorce or legal separation (specified in section 71(b)(2)(C)) and payments which fluctuate as a result of a continuing liability to pay for at least 6 years (on the assumption that neither spouse dies and that the payee spouse does not remarry) a fixed portion of income from the earnings of a business, property or services will not be taken into account.[18]

Effective Date

The provision will generally apply to divorce or support decrees and agreements executed after 1984. The provision will also apply with respect to the modification of a prior instrument where the modified instrument expressly so provides.

The identification number and penalty provision will apply to payments made after December 31, 1984.

Revenue Effect

This provision is estimated to increase revenues by $2 million in fiscal year 1985; $12 million in fiscal year 1986; $33 million in fiscal year 1987; $57 million in fiscal year 1988, and $77 million in fiscal year 1989.

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[18] See also Treasury Temporary regulations Sec. 1.71-IT and Sec. 1.215-IT for rules relating to alimony and separate maintenance payments.

3. Dependency Exemption (secs. 423 and 426 of the Act and secs. 151 and 152(e) of the Code)[19]

Prior Law

Under prior law, a $1,000 deduction, for dependency exemption, was generally allowed for each dependent child of the taxpayer. Normally, in order to qualify as a taxpayer's dependent, a child must have over half of his or her support for the year furnished by the taxpayer. The child may not have gross income of $1,000 or more in the taxable year unless the child is under the age of 19 or is a student.

In the case of children of divorced or separated parents, a special rule applied in determining which parent provided over half of the support (sec. 152(e)).

In general, a divorced or separated parent who had custody of a child for the greater part of the year (the custodial parent) could claim the dependency exemption for the child if the parents together had custody of the child for more than one-half of the year and provided more than one-half of the child's support. A special rule provided that the noncustodial parent, rather than the custodial parent, could claim the dependency exemption if (1) a decree or written agreement allocated the exemption to the noncustodial parent and the noncustodial parent paid at least $600 for the support of the child during the calendar year; or (2) the noncustodial parent provided at least $1,200 for the support of the child during the calendar year and the custodial parent did not clearly establish that he or she provided more for the support of the child than did the noncustodial parent. None of these rules applied in the case where the dependency exemption had been allocated under the special rules applying to multiple support where no one person contributed over half the support of an individual.

In addition to the dependency exemption, the deduction for medical expenses, the treatment of a parent as qualifying for either single rates or head of household rates, the earned income credit, and the credit for household and dependent care services were, in part, determined by reference to whether the parent furnishes over half of the support of a child.

Reasons for Change

The prior rules governing the allocations of the dependency exemption were often subjective and presented difficult problems of proof and substantiation. The Internal Revenue Service became in-

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[19] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, secs. 424 and 427; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1498-1500; and H. Rep. No. 98-861 (June 23, 1984), pp. 1118-1119 (Conference Report).

volved in many disputes between parents who both claimed the dependency exemption based on providing support over the applicable thresholds. The cost to the parties and the Government to resolve these disputes was relatively high and the Government generally had little tax revenue at stake in the outcome. The Congress wished to provide more certainty by allowing the custodial spouse the exemption unless that spouse waives his or her right to claim the exemption. Thus, dependency disputes between parents will be resolved without the involvement of the Internal Revenue Service.

Explanation of Provision

Under the Act, as under prior law, the parent having custody of a child for the greater portion of the year (the custodial parent) will generally be treated as having provided more than one-half of the child's support and therefore be entitled to the dependency exemption. This rule also will apply to parents not living together during the last 6 months of the calendar year, as well as those divorced or separated under a separation agreement. The Act provides three exceptions to the general rule. First, the custodial parent can release his or her claim to the exemption for the year to the noncustodial parent. For this exception to apply, the custodial parent will have to sign a written declaration that he or she will not claim the child as a dependent for the year, and the noncustodial parent will have to attach the written declaration to his or her tax return. That declaration may be made for one or more specified calendar years. The parties may make a permanent declaration a copy of which the noncustodial parent attaches to each year's return, or the declaration may be made by the custodial spouse annually in order to better insure the receipt of child support payments.

Next, as under prior law, the general rule will not apply in the case of multiple support agreements. Finally, an exception is provided to continue existing law for certain decrees or agreements which were executed before January 1, 1985, and under which the custodial parent had agreed to release his or her claim to the dependency exemption to the noncustodial parent . Thus, if such an agreement exists, the noncustodial parent may claim the dependency exemption if he or she provides at least $600 for the support of the child during the year. The parties may modify the decree or agreement to make this rule inapplicable by expressly so providing.

The Act also provides that the support by the spouse of a remarried parent will be treated as support provided by that parent in applying these rules. Thus, the holding in Revenue Ruling 78-91 (1978-1 C.B. 36) with respect to support provided by a step-parent is codified for the future.

For purposes of the medical expense deduction, any child subject to the rules described above will be treated as a dependent of both parents. Thus, a parent can deduct medical expenses paid by that parent for the child even though a dependency exemption for the child may be allowed to the other parent.

Under the Act, certain provisions are amended to provide consistent rules among various inter-related sections concerning family status of individuals living apart. The basic rule adopted is that in the prior law child and dependent care credit. An amendment is made to section 143(b) to provide that for an otherwise married individual living with a child to be considered not married, his or her spouse may not be a member of the household for the last six months of the year, rather than the entire year as under prior law. The definition of head of household status (sec. 2) is amended to provide that the household must be maintained as the principal place of abode for the child for more than one-half of the year, rather than for the entire year as under prior law. Further, the definitions of marital and head of household status, the earned income credit (sec. 32), and the child and dependent care credit (sec. 21) are amended to provide that any custodial parent who releases a claim to a dependency exemption under the above rules will be treated as entitled to the dependency exemption for the purposes of these sections. Thus, such a custodial parent could be eligible for unmarried status, head of household status, or the credits if the other conditions of those provisions are met.

Finally, the Act provides that the $1,000 dependency exemption is to be determined without regard to any income received by an individual who is permanently and totally disabled for services performed at a sheltered workshop school operated by a charity or government.[20]

Effective Date

The provision is effective for taxable years beginning after December 31, 1984.

Revenue Effect

This provision will have a negligible revenue effect.

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[20] See also Treasury Temporary regulations Sec. 1.152-4T for rules relating to dependency exemption in the case of a child of divorced parents, etc.

4. Innocent Spouse Relieved of Liability in Certain Cases (sec. 424 of the Act and secs. 66 and 6013 of the Code)[21]

Prior Law

Tax liability of spouses who file joint returns

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

Under limited circumstances, a spouse could be relieved of liability for tax (including interest and penalties) on a joint return (sec. 6013(e)). The application of this so-called innocent spouse rule was limited to cases in which the liability for tax results from an omission from gross income that exceeded 25 percent of the gross income stated in the return. In such cases, the person seeking relief must have established that the unreported income was attributable to the other spouse, and that he or she had no knowledge of (or reason to know of) the omission. The determination of the spouse to whom the unreported income is attributable was made without regard to community property laws. In addition, taking into account whether the innocent spouse significantly benefitted from the omission from income, a determination was required as to whether it would be inequitable to hold such spouse liable for the tax. In determining whether there was an omission of more than 25 percent of the income disclosed on the return, amounts as to which adequate information was provided on the return were not taken into account.

Community income of spouses who live apart

In general, if a husband and wife file separate returns, each was required to report one-half of the income attributable to community property under State law. However, if certain requirements were met, relief from tax liability was provided for an abandoned spouse (sec. 66). To qualify, a couple must have been married at some time during the calendar year, but live apart during the entire calendar year. The spouse seeking relief must not have filed a joint return, and one or both of the spouses must have earned income (*i.e.*, income attributable to the performance of personal services) that constitutes community income. In addition, no portion of the earned income (other than *de minimis* amounts) may have been transferred (directly or indirectly) between the spouses before the close of the calendar year.

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[21] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 425; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1501-1503; and H. Rep. No. 98-861 (June 23, 1984), pp. 1119-1120 (Conference Report).

If all of the above requirements were met, the applicable community property law with respect to certain types of income would be disregarded for Federal income tax purposes. Under special allocation rules (1) earned income (other than income from a trade or business or a partner's distributive share of a partnership's income) was treated as the income of the spouse who rendered the personal services, (2) income derived from a trade or business (other than that carried on by a partnership) was treated as the income of the spouse who carries on the trade or business, unless the other spouse exercises substantially all of the management and control of such trade or business, and (3) a partner's distributive share of a partnership's income was treated as the income of the partner. All other community income was characterized in accordance with the applicable community property laws.

Reasons for Change

The Congress believes that the prior law rules relieving innocent spouses from liability for tax on a joint return are not sufficiently broad to encompass many cases where the innocent spouse deserves relief. Relief may be desirable, for example, where one spouse claims phony business deductions in order to avoid paying tax and the other spouse has no reason to know that the deductions are phony and may be unaware that there are untaxed profits from the business which the other spouse has squandered.

Also there may be situations in community property states when it is inequitable to tax a spouse filing a separate return on earnings of the other spouse where the innocent spouse received no benefit from the earnings.

Explanation of Provision

The Act liberalizes the innocent spouse joint return relief provision by expanding the circumstances in which the relief may be granted. The Act also provides additional relief to a spouse who is liable for tax on community income that is attributable to the other spouse.

Joint return liability of innocent spouse

Under the Act, the innocent spouse (sec. 6013(e)) rule will apply to cases in which the tax liability results from a substantial understatement of tax that is attributable to grossly erroneous items, including claims for deductions, basis (including cost of goods sold), or credits, as well as omitted income, of the other spouse. Grossly erroneous items include any item of income that is omitted from gross income, regardless of the basis for omission. A claim for deduction or credit will be treated as a grossly erroneous item only if the claim had no basis in law or fact. The Act defines a substantial understatement as any understatement of tax that exceeds $500. As under prior law, relief may be granted only where it would be inequitable to hold the innocent spouse liable.

The joint return innocent spouse relief, to the extent the understatement is not attributable to an omission from gross income, will be available only if the liability which otherwise would qualify for relief exceeds (i) 10 percent of the spouse's adjusted gross income for the taxable year prior to which the deficiency notice is mailed if that income was $20,000 or less, or (ii) 25 percent of the spouse's adjusted gross income for the prior taxable year if that income exceeded $20,000. Where the spouse is remarried, adjusted gross income includes income of the new spouse. (Where the spouse will meet these tests, it is not necessary to actually mail the deficiency notice.)

In applying these rules, community property laws will continue to be disregarded in determining to whom an item is attributable. The Act does not specifically require that the determination of whether it would be inequitable to hold the innocent spouse liable include the consideration of whether such spouse benefitted from the erroneous item, but that factor should continue to be taken into account. The omission from income determination may apply notwithstanding that adequate information about the erroneous items was provided on the return.

Relief for separate return liability attributable to community income

The Act provides a new rule relating to the treatment of certain community income. This provision applies in cases where a spouse fails to include in gross income an item of community income that would be treated as the income of the other spouse if the special allocation rules applicable under the community-income provision of prior law had applied. This rule will apply only where the spouse seeking relief does not file a joint return for the taxable year, and establishes that, at the time the return was filed (if a return is filed), he or she had no knowledge of (or reason to know of) the item of community income. The Act also requires that a determination be made that it would be inequitable to include the unreported income in the gross income of the spouse seeking relief. This determination may take into account whether the spouse benefitted from the untaxed income and whether the defense was promptly raised so as to prevent the period of limitations from running on the other spouse.

If all of the above requirements were met, then the unreported community income will be included in the gross income of the spouse to whom the income is attributable under the special rules of allocation.

Finally, the Secretary may disallow the benefits of any community property law to a taxpayer if the taxpayer acts as if he or she is solely entitled to the income and the taxpayer failed to notify the taxpayer's spouse of that income.

Effective Date

The innocent spouse provisions will apply to all taxable years to which the Internal Revenue Code of 1954 applies. Further, the Act provides that corresponding provisions will be deemed to be included in the Internal Revenue Code of 1939, and will apply to all taxable years to which the 1939 Code applied. The effective date provided in the Act is not intended to open a year that has been closed by the statute of limitations, res judicata, or otherwise. It is intended that the additional relief in the Act will be available to any pending court case where the decision in the case is not final.

The provision relating to the disallowance of community property law benefits will apply to taxable years beginning after December 31, 1984.

Revenue Effect

This provision will have a negligible revenue effect.

5. Gift and Estate Tax Treatment of Certain Property Settlements (sec. 425 of the Act and secs. 2043 and 2516 of the Code)[22]

Prior Law

Under prior law, transfers of property (other than certain terminable interests) between spouses were not subject to estate or gift taxes.

With several exceptions, transfers of property to a former spouse in satisfaction of marital or property rights were taxable gifts. A transfer of property between former spouses was not subject to gift tax if the transfer was pursuant to a written agreement entered into not more than two years prior to divorce and is in settlement of marital or property rights or to provide a reasonable allowance for the support of minor children (sec. 2516). In addition, property transfers ordered by a divorce court having the power to order the disposition of the property were not taxable gifts.[23] Finally, the transfer of property in discharge of a former spouse's right to support was not a taxable gift.

For estate tax purposes, a claim of a former spouse based on the release of marital or property rights was not deductible in computing the taxable estate unless the claim was based on a court decree where the court had the power to determine the marital or property rights of the spouse.[24]

Reasons for Change

The Congress believes that the estate tax treatment of transfers made in settlement of marital or property rights should be conformed to the gift tax treatment. This will allow the parties to rely on a written agreement even though the payor spouse dies before the agreement is completely executed. The Congress also believes the parties should have additional time to enter into the written agreement.

Explanation of Provision

The Act allows an estate tax deduction for transfers pursuant to claims arising under a written agreement in settlement of marital or property rights where the agreement would have qualified those transfers as non-taxable for gift tax purposes (under sec. 2516). Thus, where the transferor dies prior to completing the transfers

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[22] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 426; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1504-1505; and H. Rep. No. 98-861 (June 23, 1984), p. 1120 (Conference Report).

[23] *Harris* v. *Comm'r.*, 340 U.S. 106 (1950).

[24] Id.

under the written agreement, no estate tax will be imposed with respect to the property transferred by the estate.

The Act also allows the parties one year after the divorce to enter into a written agreement.

Effective Date

This provision will apply to estates of decedents dying after July 18, 1984, and to lifetime transfers after that date.

Revenue Effect

This provision will have a negligible revenue effect.

C. Revision of At-Risk Rules (secs. 431 and 432 of the Act and secs. 46, 48 and 465 of the Code)[25]

Prior Law

Loss limitation rules

Prior and present law (sec. 465) provide an at-risk limitation on losses from business and income-producing activities other than real estate and certain corporate leasing transactions.[26] The rule is designed to prevent a taxpayer from deducting losses in excess of the taxpayer's actual economic investment in an activity.

Under the loss limitation at-risk rules, a taxpayer's deductible losses from an activity for any taxable year are limited to the amount the taxpayer has placed at risk (i.e., the amount the taxpayer could actually lose) in the activity. 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 to the activity, and (3) amounts borrowed for use in the activity with respect to which the taxpayer has personal liability or has pledged security for repayment. This amount is generally increased by the taxpayer's share of income and 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), (2) the lender has an interest (other than as a creditor) in the activity, or (3) under prior law, if the lender was a related party to the taxpayer. In the case of activities other than investments in motion picture films or video tapes, farms, oil and gas property, geothermal property, or leased personal property (generally, the areas covered by the original 1976 at-risk rules), the interested party and related party rules are applied only to the extent established by Treasury regulations. 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. Losses which cannot be deducted for any taxable year because of the loss limitation at-risk rules may be deducted in any subsequent year in which the rule does not prevent the deduction.

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[25] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, secs. 431-432; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1506-1515; H. Rep. No. 98-861 (June 23, 1984), pp. 1120-1122 (Conference Report); and H. Con. Res. 328, 130 Cong. Rec. S. 8943 (June 29, 1984), H. 7525 (June 29, 1984).

[26] The Tax Reform Act of 1976 applied the at-risk rule to four specific activities: (1) holding, producing, or distributing motion picture films or video tapes; (2) farming; (3) leasing of personal property; and (4) exploring for, or exploiting, oil and natural gas resources. The Revenue Act of 1978 extended the rule to all activities except real estate and certain equipment leasing engaged in by closely held corporations.

Under prior and present law, the loss limitation at-risk rules are applicable to individuals and to closely held corporations more than 50 percent of the stock in which was owned, at any time during the last half of the taxable year, by or for 5 or fewer individuals.[27] Stock ownership for this purpose is generally determined according to the rules applicable for purposes of identifying a personal holding company (sec. 542(a)(2)). In the case of a partnership or S corporation, the rules apply at the partner or shareholder level.

The loss limitation at-risk rules are applied on an activity-wide basis. Prior law provided that a taxpayer's activity with respect to any individual film, farm, oil and gas property, geothermal property, or leased personal property was treated as a separate activity. Thus, a taxpayer generally could deduct losses from an oil and gas property, for example, only to the extent it was at risk with respect to that specific property. However, prior law allowed aggregation, under certain conditions, of films, farms, and oil, gas, geothermal and leasing properties owned by a partnership or S corporation. With respect to other types of investment, activities were treated as one activity (i.e., aggregated) if the activities constituted a trade or business and the taxpayer actively participated in the management of that trade or business (in the case of partnerships or S corporations, if 65 percent or more of losses were allocable to persons who actively participated in the management of the trade or business). A taxpayer could thus deduct losses from these activities based on the extent of his at-risk investment in an entire actively managed trade or business. The Treasury Department was authorized to prescribe regulations regarding the aggregation or separation of these activities for purposes of the at risk rules (sec. 465(c)(3)(C)).

Investment tax credit rules

The Economic Recovery Tax Act of 1981 provided that the allowance of the investment tax credit was subject to an at-risk limitation. The limitation applied to the same activities and the same category of taxpayers that were subject to the at-risk loss limitation rules. Thus, the investment credit at-risk rules applied to individuals and closely held corporations that were engaged in a trade or business or other income-producing activity (other than real estate and certain corporate leasing).

Under the investment tax credit at-risk rules, the credit was not allowed for amounts invested in qualifying property to the extent the invested amounts were not at risk within the meaning of the loss limitation provisions (sec. 465(b)). Amounts generally were not considered at risk if (1) the amount was borrowed and the taxpayer was not personally liable for repayment of the debt (nonrecourse debt), (2) the lender had an interest (other than a creditor) in the business activity in which the property is used, (3) the lender was a related party to the taxpayer, or (4) the taxpayer was protected against the loss of the invested amount.

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[27] The at-risk rule was extended to closely held corporations in 1978.

Prior law provided two exceptions to the investment credit at-risk rules. Under the first exception, amounts borrowed (other than convertible debt) with respect to qualifying investment tax credit property no later than the taxable year the property was placed in service were generally considered at risk if (1) the taxpayer at all times had a minimum 20-percent at-risk investment in the property (determined without regard to the exception) and (2) the amount borrowed was owed to either a qualified lender or a Federal, State, or local government, or was guaranteed by a Federal, State or local government. Qualified lenders included banks, savings and loan institutions, credit unions, insurance companies, qualified pension trusts, and other persons actively and regularly engaged in the business of lending money.

For the qualified lender exception to apply, the lender must not have been related to the taxpayer. The qualified lender could also not have been a person who received a fee with respect to the taxpayer's investment in the qualifying property (e.g., a promoter) or a person related to such person. The exception also did not apply if the taxpayer had acquired the property from (1) the qualified lender (or a person related to the lender) or (2) a person related to the taxpayer.

Prior law also applied a safe harbor exception for certain level payment loans related to qualified energy property.

In the case of a partnership or S corporation, the investment credit at-risk rule applied at the partner or shareholder level. Thus, the calculation of amounts at-risk was made by each partner or shareholder to whom the at-risk rules applied. Amounts for which a partnership or S corporation were considered at risk under the qualified lender exception were allocated among the partners or shareholders according to the rules for allocation of the investment tax credit. However, this allocation rule did not apply for purposes of determining whether each partner or shareholder had a minimum 20-percent at-risk investment in the property. Thus, to benefit from the qualified lender exception, each partner or shareholder must have had a proportionate 20-percent at-risk investment in the property, determined under the general rule (i.e., the partner or shareholder must have contributed cash or been personally liable for borrowed funds in this amount).

The at-risk limitation on the investment tax credit applied to property placed in service on or after February 19, 1981. An exception was provided for property placed in service on or after that date if the property was acquired by the taxpayer under a binding contract entered into before February 19, 1981.

Credit pass-through leases

Prior and present law (sec. 48(d)) allow a lessor of new investment tax credit property to elect to transfer ("pass through") the credit to the lessee, subject to certain conditions. For certain short-term leases, only a portion of the credit may be transferred.

The prior law at-risk rules did not specifically indicate how the rules apply in the case of a pass-through lease. Some lessees apparently took the position that the rules did not apply to the lessee, thus effectively rendering the rules inapplicable to certain lease transactions. Many of these lessees appear to have claimed the credit although the lessee (and in some cases, the lessor) had little or no at-risk investment in the property.

Legislative background

The loss limitation at-risk rule was first adopted by Congress in 1976, and later expanded in 1978, in order to limit the incentives for taxpayers to reduce their tax liability by investing in tax shelter activities in which they were not subject to real economic risk. The investment tax credit at-risk rule was adopted for similar reasons in 1981.

In general, the at-risk rules limit a taxpayer's tax benefits from an activity to those benefits attributable to funds which the taxpayer has personally invested in an activity (in the case of the loss limitation rule) or a property (in the case of the investment tax credit rule), including funds which the taxpayer borrowed and is personally liable to repay. In the case of property which is seller-financed (or financed by a party related to the seller), this reduces the incentive for the parties to inflate the purchase price in order to give the purchaser additional tax deductions (for depreciation or accrued interest) or an inflated investment tax credit. In these situations, the buyer may otherwise be unconcerned about the higher price, since the property may simply be repossessed by the seller after the buyer has benefited from the inflated deductions or credits. The at-risk rules also prevent tax benefits from accruing to a purchaser who has no real equity in a property because the property's value is, or may become, less than the face amount of a nonrecourse loan on the property. In these situations, the purchaser may be receiving tax benefits without bearing the economic burden of any corresponding decline in the property's value. In addition, the at-risk rules reduce the situations in which taxpayers may fail to "recapture" income or credits from the disposition of tax shelter property since, under the at-risk rules, the deductions would not originally have been allowed.

Reasons for Change

Investment tax credit rules

The Congress was concerned that the investment tax credit at-risk rules contained in ERTA had generated significant confusion among taxpayers and inhibited certain non-tax shelter transactions. It appeared that the interdependence of the loss limitation at-risk rules (which are applied on an activity-wide basis) and the investment tax credit rule (which must be applied on a property-by-property basis) was largely responsible for this confusion. By fashioning an independent rule for the investment tax credit, and adjusting the application of the qualified lender rule, the Congress believes it has created a workable and fair new provision. In order to avoid any inequities which may result from application of the ERTA rules, the Congress has made the new provisions applicable (at the taxpayer's election) as if included in ERTA.

With regard to the pass-through of the investment tax credit to a lessee, the Congress was concerned that taxpayers had taken positions effectively avoiding the application of the at-risk rules to tax shelter lease transactions. To prevent persons from taking these positions, the Act specifically applies the at-risk rule to the lessee based on the minimum rent for which the lessee is personally liable under the lease. This is consistent with the general principle that a credit (or deduction) should be allowed only where a taxpayer bears a real economic risk. To further reduce the possibility that a lessee may claim an inflated value for property subject to a pass-through lease, the Act also generally subjects the lessor to the at-risk rules unless both the lessor would not otherwise be subject to the rules and the property was manufactured or produced by the lessor or has an ascertainable fair market value.

General concerns

The Congress believed that the at-risk rules generally (including the loss limitation and investment tax credit at-risk rules) should continue to apply in those situations where tax shelter possibilities—i.e., overvaluation of assets or transfer of tax benefits to a party with no real equity in the property—present themselves. However, where non-recourse financing constitutes bona fide financing in which the debtor has a real equity interest in the property and is likely to make all payments for the property, and where repossession is unlikely, these tax shelter elements are not present and the at-risk rules are not needed. The Act identifies these situations by excluding from the at-risk rules active closely held corporate businesses, subject to certain minimum business activity requirements. This change will eliminate the competitive disadvantage encountered by certain closely held businesses which have been prevented from utilizing legitimate nonrecourse financing (or recourse financing by active subsidiaries) by the at-risk rules.

In addition to the changes above, the Act makes certain adjustments regarding the aggregation of activities for at-risk purposes and borrowing from related parties, consistent with the underlying policy of the at-risk rules.

Explanation of Provision

Revision of investment tax credit at-risk rules

Under the Act, the investment tax credit at-risk rules are revised. Instead of applying the loss limitation (sec. 465) at-risk rules directly, the Act reduces the credit base for the investment tax credit by the amount of nonrecourse financing, other than certain commercial financing, with respect to a property. However, the general concepts of the at-risk rules will continue to apply.

Under the Act, the basis (or cost, in the case of used property) of property for purposes of determining the investment tax credit is to be reduced by the amount of nonrecourse financing (not including qualified commercial financing) with respect to the property. The provision applies to the same taxpayers and the same activities that are currently subject to the at-risk rules. Nonrecourse financing includes amounts with respect to which the taxpayer is protected against loss through guarantees, stop-loss agreements, or other similar agreements. Except to the extent otherwise provided by regulations, nonrecourse financing also includes amounts borrowed from a person who has an interest (other than as a creditor) in the activity in which the property is used or from a person related to such a person (not including a person solely related to the taxpayer). This rule does not apply to amounts borrowed by a corporation from its shareholders. Nonrecourse financing does not include financing with the taxpayer's own funds which did not result from borrowing. It is expected that the Treasury regulations may except "arms-length" recourse borrowing from otherwise unrelated commercial lenders from the prohibition against borrowing from a person with an interest in the activity (or person related to such person).

The Act provides an exception for qualified commercial financing similar to that under prior law. Qualified commercial financing includes financing (other than convertible debt) provided or guaranteed by any Federal, State or local government, or borrowed from a qualified person. Qualified persons include any person actively and regularly engaged in the business of lending money. However, qualified persons do not include (1) any person related to the taxpayer, (2) any person from which the taxpayer acquired the property (or a person related to such person), or (3) any person who receives a fee (e.g., a promoter) with respect to the taxpayer's investment in the property (or a person related to such person). For these purposes, the Act adopts the definition of related person contained in section 168(e)(4) (relating to accelerated cost recovery). Under this rule, related persons generally include family members, fiduciaries, and corporations or partnerships in which a person has at least a 10-percent interest.

In order for the exception for qualified commercial financing to apply, the amount of nonrecourse financing with respect to the property cannot exceed 80 percent of the credit base. Additionally, the exception does not apply where property was acquired by the taxpayer from a related person.

The prior law safe harbor rule for certain energy property is continued under the Act, with conforming changes.

The Act provides that, in the case of partnerships or S corporations, the determination of whether financing is nonqualified nonrecourse financing is to be made at the partner or shareholder level. However, a special rule is provided for financing provided by a qualified person to an S corporation. Under this rule, an allocable share of such financing is treated as recourse to an S shareholder if the financing is recourse at the corporate level and is provided with respect to qualified business property. Such financing will therefore not count as nonqualified nonrecourse financing and will not reduce the credit base, regardless of whether the shareholder is personally liable for repayment. Qualified business property includes property used by the S corporation in an active trade or business which during the entire 12-month period ending on the last day of the taxable year has at least three full-time non-owner employees (as defined for purposes at the exemption for active closely held businesses) substantially all of whose services are directly related to the business. One full-time employee must also be involved in the active management of the business. Qualified property does not include master sound recordings[28] or other tangible

[28] See also new Code section 48(r) for rules relating to sound recordings.

or intangible assets associated with literary, artistic or musical properties. The amount of any partner's or shareholder's allocable share of any financing will be determined according to the rules for allocation of the investment tax credit.[29]

The Act also includes rules for the treatment of subsequent increases and decreases in nonqualified nonrecourse financing. These provisions are generally consistent with the treatment of changes in the at-risk amount under prior law.

Credit pass-through leases

The Act provides specific at-risk rules applicable to lessees under credit "pass-through" leases. These rules generally apply to the same types of taxpayers and the same activities as the at-risk rules generally. Additionally, the Act provides special criteria for application of the general investment tax credit at-risk rules to lessors under credit pass-through leases.

Application of general at-risk rule to lessors.—In order to reduce the possibility that a lessee may claim an inflated value for leased property, the Act provides that the lessor under a credit pass-through lease will be subject to the investment tax credit at-risk rules with respect to the leased property unless the lessor would not otherwise be subject to these rules and (1) the lessor manufactured or produced the property, (2) the property has a readily ascertainable fair market value, or (3) the Secretary determines by regulation that it is unnecessary for the lessor to be subject to the applicable at-risk rules. If neither condition (1), (2), nor (3) is satisfied, the lessor will be subject to the investment tax credit at-risk rules with respect to the lease, even if it would not generally be subject to the at-risk rules. If the lessor is subject to at-risk rules with respect to the lease, the amount of the credit which may be passed through will be reduced by the amount of the nonqualified nonrecourse financing with respect to the lessor.

Lessee at-risk rules.—Under the credit pass-through at-risk rules, the lessee initially is allowed the full investment tax credit only if the lessee is at risk for (i.e., is obligated to make) rental payments the present value of which is equal to at least a "minimal" percentage of the the lessee acquisition amount. This minimal percentage is an amount equal to two times the credit percentage (set forth in section 46(a)) plus 10 percent (60 percent of this amount in the case of 3-year property).[30] The lessee acquisition amount is the amount for which the lessee is treated as having acquired the property under the general rules for pass-through of the investment tax credit (i.e., without regard to the amount at risk).[31]

For purposes of the pass-through rules, the lessee is considered to be at risk for rental payments which the lessee is required to make under the lease in all events, and for which the lessee is not pro-

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[29] If an amount does not qualify to be treated as recourse to the S shareholder in one year but does qualify in a subsequent year, because the business then meets the qualification requirements, the credit may be allowed in the subsequent year (sec. 46(c)(9)).

[30] For purposes of this rule, the credit percentage is to reflect any election to reduce the credit percentage under section 48(g).

[31] In the case of a multiple pass-through, an intermediate lessor may pass through only that portion of the credit which such intermediate lessor would itself be entitled to take under the lessee at-risk rules.

tected against loss through nonrecourse financing, guarantees, stop-loss arrangements, or other similar arrangements. The present value of at-risk rental payments is to be determined by discounting all future minimum required payments by the rate in effect (as of the time the lease is entered into) for determining interest on underpayments of tax (sec. 6621).

Where the lessee is at risk for rental payments the present value of which is less than the minimal percent of the lessee acquisition amount as set forth above, the lessee is allowed only a portion of the credit. The portion of the full credit allowed for any taxable year is that portion equal to the ratio of (1) the aggregate rental payments actually made during the taxable year to (2) the lessee acquisition amount. The full remaining amount of the credit is allowed in the first year in which the lessee has made aggregate rental payments equal to at least the minimal percent of the lessee acquisition amount. For example, a lessee who makes rental payments with respect to property (to which sections 46(a) (2) and (3) and 48(g)(4) do not apply) equal to 10 percent of the lessee acquisition amount in each of years 1 and 2 (and who is not otherwise at risk for rental payments equal to at least 30 percent of the lessee acquisition amount) will be allowed one-tenth of the credit in each of those years. If the lessee makes a further 10 percent payment in year 3 (resulting in aggregate payments of 30 percent of the lessee acquisition amount), the lessee will be allowed the full remaining amount of the credit.

The Act provides that, for purposes of applying the lessee at-risk rule to partnerships and S corporations, rules similar to those in effect under the general investment tax credit at-risk rules shall apply (i.e., the partners and shareholders must individually be at risk for their share of the minimum lease payments). Additionally, the treatment of subsequent reductions in the lessee's at-risk amount (e.g., by entering into guarantees or stop-loss arrangements with respect to future rental payments) are to be based on the principles applied under the general rule (sec. 47(d)). For purposes of the recapture rule, where the lessee actually made a rental payment, the determination of the lessee's at-risk amount is to be determined as if he were still at risk to make that payment.

The Act provides the Treasury Department with authority to prescribe regulations necessary to carry out the purposes of the lessee at-risk rules. Specifically, the Treasury is provided with authority to prescribe regulations providing appropriate adjustments to required rental payments where the lessor bears expenses connected with the lease which a lessee normally would bear,[32] and specifying the extent to which contingencies in the lease will be disregarded for at-risk purposes. It is expected that these regulations will take into account the normal business practices associated with lease transactions, such as forgiveness of rental payments where the property is destroyed or damaged. The option of the lessee to unilaterally terminate a lease is not a contingency to be disregarded for at-risk purposes. However, the regulations may provide that if termination of a lease is permitted upon payment of a

[32] No inference is intended that the Treasury would not have this authority without specific statutory authorization.

fixed amount, the lessee is to be considered at-risk for the lesser of the present value of the noncontingent amount or the present value of future rental payments that would be due after the date on which the lease could be terminated. The lessee's right to substitute other leased property in the future (e.g., a newer model of a leased computer) is a contingency which may be disregarded if the minimum rental payments under the lease are not reduced upon such substitution.

Exclusion for active closely held businesses

Under the Act, certain active businesses conducted by closely held subchapter C corporations are exempted from the at-risk rules, including both the loss limitation and investment tax credit at-risk rules. (Non-closely held corporations continue to be exempt from the at-risk rules.) The exemption does not apply to personal holding companies (as defined in sec. 542(a)), foreign personal holding companies (as defined in sec. 552(a)), or personal service corporations (as defined in sec. 269A(b), but using a 5-percent shareholder test). Additionally, the exemption does not apply to (1) equipment leasing businesses, as defined under sec. 465(c)(6)[33], or (2) any business involving the exploitation, sale, or lease of master sound recordings, motion picture films, video tapes or other tangible or intangible assets associated with literary, artistic, musical or similar properties (unless the taxpayer is at risk with respect to all amounts paid or incurred or chargeable to capital account in the business). The provision of radio, television, cable television, or similar services pursuant to a license or franchise granted by the Federal Communications Commission or other Federal, State or local authority is not to be treated as an excluded business under this rule.

Under the Act, the exemption from at-risk applies to active corporate businesses only if, during the entire 12-month period ending on the last date of the corporation's taxable year, the corporation had at least three full-time non-owner employees substantially all of whose services were directly related to such business. Also, at least one full-time employee of the corporation (but not necessarily a non-owner employee) must perform services substantially all of which are in the active management of the business. In addition, the deductions for business expenses attributable to the business for the taxable year under sections 162 (relating to trade or business expenses) and 404 (relating to contributions to certain employee benefit plans) must exceed 15 percent of the gross income from the business. For purposes of this 15-percent requirement, deductions for compensation for personal services rendered by certain owner-employees of the corporation, or a member of a their family, are excluded from the computation amount. In the case of a bank or other financial institution, gross income includes tax-exempt interest, and amounts paid to depositors as interest or dividends are treated as business expenses. The 15-percent test will not apply to any insurance business conducted by a qualified life insurance com-

[33] Certain corporate equipment leasing businesses are presently exempt from the at-risk rules.

pany (i.e., a company which would be a life insurance company determined without regard to its unearned premiums).

For purposes of the three-employee requirement, non-owner employees include any employee who does not own (directly or indirectly) more than 5 percent of the outstanding stock of the corporation at any time during the taxable year.

For purposes of the exemption for active closely held businesses, members of an affiliated group of corporations (sec. 1504(a)) are treated as a single taxpayer, except that the income of a personal holding company or personal service corporation may not be offset by losses of any other member of the group.

The Act provides that, for purposes of the three-employee rule, a qualified corporate partner may take into account its proportionate share of the employees of the partnership (or of a qualified corporate partner) substantially all the services of whom are directly related to the business of the partnership. Additionally, a qualified corporate partner will take into account its proportionate share of the income and deductions of the partnership for purposes of determining whether the corporation is engaged in a qualifying business. (The corporation may aggregate its share of partnership employees and deductions with any portion of the business which it conducts directly.) A qualified corporate partner is a general partner that is itself a corporation, that has at least a 10-percent interest in the profits and losses of the partnership, and has contributed money or property equal in value to the lesser of $500,000 or 10 percent of the corporation's net worth to the partnership as of the end of the taxable year. In addition, for these rules to apply, the partnership must be engaged in an active trade or business and there must be at least one full-time employee of the partnership (or of a qualified corporate partner) substantially all of whose services are in the active management of the business.[34] For purposes of these rules, a corporation's proportionate share of partnership activities is to be determined on the basis of its profits interest.

Aggregation of activities

For purposes of the loss limitation at-risk rule, the Act provides that all leased section 1245 properties (i.e., certain depreciable personal property) which are placed in service in any taxable year of a partnership or S corporation shall be treated as a single activity. In addition, the authority of the Treasury Department to aggregate or separate activities under section 465(c)(3)(C) is extended to the activities (including activities conducted by partnerships or S corporations) described in section 465(c)(2) (i.e., films, farms, oil, gas, and geothermal properties, or leased personal properties).

Treatment of certain borrowing

The Act deletes the prior law provision under which a taxpayer with recourse borrowing from related parties (including family members and entities controlled by the taxpayer) was not considered to be at risk for purposes of the loss limitation and investment

[34] When this rule applies, the requirement of one full-time managerial employee will not be applied to the qualified corporate partner (i.e., this rule will be applied only at the partnership level only).

tax credit at-risk rules. However, it is intended that, where the related party has itself borrowed the funds on a nonrecourse basis, the lending may nevertheless be treated as nonrecourse.

The Act further provides that, except to the extent provided in regulations, recourse borrowing will not be considered at risk where the lender has an interest (other than as a creditor) in the activity or is related to a person (other than the taxpayer) having such an interest.[35] However, the Act specifies that a corporation may be considered at risk with respect to amounts borrowed from its shareholders to finance participation in an activity.

Effective Date

The provisions regarding the exclusion for closely held businesses, aggregation of activities, and the treatment of certain borrowing from related parties under section 465 apply to taxable years beginning after December 31, 1983. Losses from active closely held businesses which are exempted from the at-risk rules by the Act, the deduction of which was deferred by previous operation of the at-risk rules, will be deductible for the first taxable year of the taxpayer beginning after December 31, 1983.

The revision of the investment tax credit at-risk rules (including the provisions regarding credit pass-through leases) applies to property placed in service after July 18, 1984. At the election of the taxpayer, the investment tax credit provisions may be applied as if included in the ERTA. Any such election will apply to all property of the taxpayer to which the ERTA rules applied. The time and manner for making such an election are to be prescribed by Treasury regulations.[36]

Revenue Effect

This provision will have a negligible revenue effect.

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[35] Where a taxpayer had previously deducted amounts as a result of being at risk under prior law, but the taxpayer would no longer be at risk because of the amendments made by the Act, it is not intended that those previously deducted amounts be recaptured.

[36] See Temp. Treas. Reg. sec. 5h.4(a), 49 Fed. Reg. 35486 (Sept. 10, 1984).

D. Miscellaneous Treasury Administrative Provisions

1. Simplification of Certain Reporting Requirements (sec. 441 of the Act)[37]

Prior Law

Under prior and present law, the Department of the Treasury is required to report to the Congress regarding specific statutory provisions on an annual or other periodic basis. The provisions affected by the Act are discussed below.

International boycotts.—The Treasury Department was required by statute to submit an annual report on the international boycott provisions of the Internal Revenue Code.[38] This report was to set forth the number of boycott reports filed for taxable years ending with or within that year, the number of such reports on which the taxpayer indicated boycott participation or cooperation, and a detailed description of the manner in which the boycott provisions of the Code have been administered during that calendar year. The Secretary was to transmit this report as soon after the close of each calendar year as the data became available.

Possessions corporations.—The Committee reports on the Tax Reform Act of 1976 required an annual report to the House Committee on Ways and Means and the Senate Committee on Finance on possessions corporations. The Committee reports stated that "The Treasury is to submit an annual report . . . setting forth an analysis of the operation and effect of the possessions corporation system of taxation. Among other things, the report is to include an analysis of the revenue effects of the provision as well as the effects on investment and employment in the possessions."[39] The Committee reports indicated that these annual reports were to be submitted within 18 months following the close of each calendar year.

High income taxpayers.—The Tax Reform Act of 1976 required the Department of the Treasury to publish information annually on the amount of tax paid by individual taxpayers with high total incomes.[40] That Act required calculation of total income in the following three ways: (1) adjusted gross income (AGI) plus tax preference items (which are exclusions from gross income or deductions in arriving at AGI), (2) AGI less investment interest and expense (to the extent that it does not exceed investment income), and (3)

[37] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 461; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1548-1550; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 831; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 784-785; and H. Rep. No. 98-861 (June 23, 1984), p. 1123 (Conference Report).

[38] Sec. 1067 of the Tax Reform Act of 1976 imposed this requirement.

[39] H. Rep. No. 94-658, 94th Cong., 1st Sess. 259; S. Rep. No. 94-938, 94th Cong., 2d Sess. 282.

[40] Sec. 2123 of the Tax Reform Act of 1976 imposed this requirement.

AGI with both of these modifications. That Act also required publication of the number of individuals with total incomes of over $200,000 who owe no Federal income tax and the deductions, exclusions, or credits they used to avoid tax.

Reasons for Change

The Congress believed that the Treasury reporting requirements could be lessened without diminishing the usefulness of information supplied in the reports. The Congress understood that the Treasury will make current the statistics of income reports relating to foreign income.

Explanation of Provision

The Act modifies several of the statutory Treasury Department reporting requirements.

International boycotts.—The Act requires the Secretary to submit an international boycott report for every four-year period. The first four-year period will begin with calendar year 1982. The data required would be the data required under current law, for a four-year period rather than a one-year period. The report will be due as soon after the close of each four-year period as the data become available.

Possessions corporations.—The Secretary will be required to submit a report setting forth an analysis of the operation and effect of the possessions corporations provisions for calendar 1981 and for each second calendar year thereafter. The possessions corporations report will be due 24 months following the close of each such second year.

High income taxpayers.—The Act requires the Secretary of the Treasury to publish information annually on the amount of tax paid by individual taxpayers with high total incomes. Total income could be calculated and set forth by adding to adjusted gross income any tax preference items excluded from or deducted in arriving at AGI, and by subtracting any investment expenses incurred in the production of such income to the extent of the investment income. The Act also requires publication of the number of individuals with total incomes of over $200,000 who owe no Federal income tax and the deductions, exclusions, or credits that they used to avoid tax.

Effective Dates

The new rule for international boycott reports applies to reports for periods after December 31, 1981. The new rule for possessions reports applies to reports for calendar years after 1980. The new rule for high income taxpayer reports applies to information published after July 18, 1984 (date of enactment).

Revenue Effect

This provision will have a negligible revenue effect.

2. **Removal of $1 Million Limitation on Working Capital Fund (sec. 442 of the Act and sec. 322(a) of Title 31)**[41]

Prior Law

Under prior and present law, the Treasury Department's Working Capital Fund provides for the financing of centralized, Department-wide services such as printing procurement, reproduction, telephone, and teletype functions (31 U.S.C. 322(a)). Under prior law, the fund was limited to a capitalization of $1 million. This limitation was set in 1970 when the Fund was established.

Reasons for Change

The Congress believed the ceiling on the Working Capital Fund was unnecessary and should be removed.

Explanation of Provision

Under the Act, the $1 million limit on the Working Capital Fund of the Department of Treasury is removed.

Effective Date

This provision became effective on July 18, 1984.

Revenue Effect

This provision will have a negligible revenue effect.

[41] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 462; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), p. 1551; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 832; S. Prt. 98-169, Vol. I (April 2, 1984), p. 786; and H. Rep. No. 98-861 (June 23, 1984), p. 1123 (Conference Report).

3. Increase in Limitation on Revolving Fund for Redemption of Real Property (sec. 443 of the Act and sec. 7810 of the Code)[42]

Prior Law

Under prior and present law, if real property on which the United States has or claims a lien is sold to satisfy a lien prior to that of the United States, the Internal Revenue Service may redeem the property generally within 120 days of the sale date (sec. 7425). This redemption right is exercised, however, only when the Service concludes that the sale price of such real property is significantly below the fair market value and if the sale price does not provide sufficient receipts to cover the government's lien.

All expenses necessary for the redemption by the Service of such real property are chargeable to a revolving fund. The fund is repaid upon a subsequent sale of the property. Under prior law, the authorization for this fund may not exceed $1 million. This figure was established in 1966.

Reason for Change

The Congress believed that the monetary interests of the United States would be better protected if additional funds were authorized for the revolving fund for the redemption of property. Because of increases in the numbers of taxpayer delinquencies, escalating real property values, and a greater frequency in foreclosures, the prior $1 million authorization for the revolving fund was insufficient to provide for all those cases where redemption of real property sold to satisfy a lien prior to that of the United States would be prudent.

Explanation of Provision

The authorization limitation on the real property redemption revolving fund is increased to $10 million.

Effective Date

The provision became effective on July 18, 1984.

Revenue Effect

This provision will not have a direct revenue effect. If pursuant to the increased authorization, additional funds are appropriated for the revolving fund and redemption rights are exercised more frequently, revenues could be increased.

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[42] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 463; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), p. 1552; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 833; S. Prt. 98-169, Vol. I (April 2, 1984), p. 787; and H. Rep. No. 98-861 (June 23, 1984), p. 1123 (Conference Report).

4. Removal of $1,000,000 Limitation Authority to Dispose of Obligations (sec. 444 of the Act and sec. 324(b) of 31 U.S.C.)[43]

Prior Law

Under prior and present law, the Secretary of the Treasury has special authority, outside of the context of the Federal Property and Administrative Services Act of 1949, to dispose of obligations acquired by the Secretary for the United States or transferred to the Secretary by an executive agency. The Secretary may also make arrangements to extend the maturity of such obligations. The Secretary is authorized to dispose or extend the maturity of obligations "in the way, in amounts, at prices, and on conditions the Secretary considers advisable and in the public interest."

The provision was enacted in 1945, as part of the Public Debt Act of 1945. It was designed, among other things, to allow for the expeditious disposition of obligations without the market disruption and loss that might be attendant on lengthy disposal procedures, including a three-month advertising requirement then applicable. Since its enactment in 1945, it has contained a limitation of $1,000,000 on the maximum par value of obligations of one issuer that could be held for such disposition. If no-par obligations are involved, the $1,000,000 limitation applies to the stated or book value of such obligations.

Reasons for Change

Because of inflation and changes in the capitalization of entities in which the United States has acquired an interest, Congress believed that the $1 million limitation is no longer appropriate. That limit has restricted the ability of the Secretary to obtain the best value for the United States in disposition transactions.

Explanation of Provision

The Act repeals the $1,000,000 limitation of the Secretary's special authority to dispose of obligations.

Effective Date

The provision became effective on July 18, 1984.

Revenue Effect

This provision has no revenue effect.

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[43] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 464; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), p. 1553; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 834; S. Prt. 98-169, Vol. I (April 2, 1984), p. 788; and H. Rep. No. 98-861 (June 23, 1984), p. 1123 (Conference Report).

5. Secretary of Treasury Authorized to Accept Gifts and Bequests (sec. 445 of the Act and sec. 321(d) of 31 U.S.C.)[44]

Prior Law

Under prior and present law, the Treasury Department has authority to accept voluntary services in connection with the sale of public debt obligations (31 U.S.C. 21). Also, the Department has joint authority with the General Services Administration to accept gifts for the purpose of reducing the national debt (31 U.S.C. 3113) and for defense purposes (50 U.S.C. 1151). However, under prior law, the Secretary of the Treasury did not have general authority to accept gifts and bequests on a department-wide basis to carry out departmental functions. The Comptroller General has ruled that agencies may not accept gifts and bequests for assisting them in carrying out governmental functions in the absence of specific authorization (36 Comp. Gen. 268). At present, there are numerous statutes authorizing various agencies to accept gifts in connection with their operations, *e.g.*, the Department of Commerce (15 U.S.C. 1522), the Department of Transportation (49 U.S.C. 1657 (m)), and the Department of Housing and Urban Development (42 U.S.C. 3535(k)). In addition, department-wide gift authority is possessed by the Departments of Agriculture and State and numerous other agencies for the conduct of agency activities.

Reasons for Change

Congress believed that the Treasury Department should be authorized to accept departmental gifts in the same way as other departments are authorized.

Explanation of Provision

The Act authorizes the Secretary of the Treasury to accept gifts and bequests of property for the purpose of aiding or facilitating the work of the Department of Treasury. Gifts and bequests of money and the proceeds from sales of other property so received will be deposited in a separate fund of the Treasury to be disbursed upon the Secretary's order.

The Secretary annually must publicly disclose the source of the gifts and bequests and the purposes for which any expenditures are made.

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[44] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 465; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), p. 1554; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 835; S. Prt. 98-169, Vol. I (April 2, 1984), p. 789; and H. Rep. No. 98-861 (June 23, 1984), p. 1123 (Conference Report).

Effective Date

The provision became effective on July 18, 1984.

Revenue Effect

The provision will have a negligible revenue effect.

6. Extension of time for Court Review of Jeopardy Assessment Where Prompt Service Not Made on United States (sec. 446 of the Act and sec. 7429 of the Code)[45]

Prior Law

Prior and present law provides that, generally, the Internal Revenue Service may not assess any income tax without sending a written notice of deficiency allowing the taxpayer 90 days in which to petition the Tax Court for review of the Service's determination. No assessment may be made until after the 90-day period has expired or, if a petition is filed, until after a decision of the Tax Court is final.

These deficiency procedures need not be followed, however, when the I.R.S. reasonably believes that collection of an alleged deficiency would be jeopardized by delay. In such a case, the Service may immediately assess and collect the tax (secs. 6851 and 6861).

In jeopardy assessment cases, the taxpayer is entitled to an expedited review by the Secretary, through the district director, of whether the determination of jeopardy was reasonable under the circumstances and whether the amount assessed and demanded was appropriate under the circumstances (sec. 7429). After review by the district director, the taxpayer is also entitled to a review by the appropriate United States District Court. Under prior and present law, the District Court must decide whether the determination of jeopardy was reasonable under the circumstances and whether the amount of the assessment was appropriate under the circumstances. This decision must be made within 20 days after an action by a taxpayer for review of the Secretary's determination is commenced. This action is a suit against the United States and, therefore, requires that the United States be given notice. However, under prior law, neither the applicable statute (sec. 7429) nor the Federal Rules of Civil Procedure required service of notice of the action to be served on the United States within the 20-day period.

Reasons for Change

Congress wished to assure adequate time for the United States to respond before a decision must be entered in any suit brought by a taxpayer for a review of a jeopardy action.

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[45] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 466; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1555-1556; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 836, S. Prt. 98-169, Vol. I. (April 2, 1984), pp. 790-791; and H. Rep. No. 98-861 (June 23, 1984), p. 1123 (Conference Report).

Explanation of Provision

Under the Act, if the District Court determines that proper service was not made on the United States within 5 days of the date on which the action is commenced, the 20-day period for action by the District Court will not begin to run until the day proper service was made on the United States.

Effective Date

This provision applies to actions commenced after July 18, 1984.

Revenue Effect

The provision will have a negligible revenue effect.

7. Extension of Period to Assess Unpaid Taxes (sec. 447 of the Act and sec. 6501 of the Code)[46]

Prior Law

Prior and present law generally limit the period for assessing taxes to three years beginning with the date the return is filed or the due date of the return, whichever is later. This general rule is modified for fraudulent returns, returns involving a substantial omission of income and in several other appropriate circumstances. There was no provision in prior law, however, which permitted extending the period for assessment solely for purposes of processing an amendment to an original return and assessing additional taxes due.

Reason for Change

Under prior law it was very difficult for the Internal Revenue Service to assess additional tax reported on amended returns filed on, or just prior to, the expiration of the period for assessment of taxes on the original return. The Act therefore extended the time for assessment of amounts shown on certain amended returns.

Explanation of Provision

Section 6501 is amended to provide that if a taxpayer amends an original return to show an increase in tax liability within 60 days of the expiration of the period for assessment of tax, the period for assessment will be extended solely to allow the IRS 60 days from the date the amendment is received to process the amendment and assess the additional tax shown thereon. This change will assure that additional tax due as reported by a taxpayer on an amended return may be assessed and collected.

Effective Date

The provision is effective for amended returns received after July 18, 1984.

Revenue Effect

This provision will increase revenues by a negligible amount.

[46] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 467, H. Rep. No. 98-432, Pt. 2 (March 5, 1984), p. 1557; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 837; S. Prt. 98-169, Vol. I (April 2, 1984), p. 792; and H. Rep. No. 98-861 (June 23, 1984), p. 1123 (Conference Report).

8. Lien on Assets of Financial Institutions for Unpaid Drafts (sec. 448 of the Act and sec. 6311(b) of the Code)[47]

Prior Law

Under prior and present law (sec. 6311(b)(2)), if a certified, treasurer's or cashier's check received in payment of taxes is not duly paid, the United States has a lien upon all assets of the bank or trust company on which drawn. This rule also provides a lien against the assets of the issuer of a money order. The lien is a preferred claim and consequently permits the Service to treat such payments as the equivalent of cash for the purposes of releasing a Federal tax lien encumbering a taxpayer's property. The taxpayer retains ultimate liability if the IRS is unable to collect from the bank or trust company.

Reasons for Change

There have been many changes in the activities of financial institutions during the past few years. Mutual savings banks, credit unions and savings and loan associations generally provide checking account services that were not anticipated when the provisions of prior law were enacted. In addition, these institutions may certify checks and issue instruments that are viewed by the general public as equivalent to the traditional cashier's check issued by a commercial bank, and should be so treated for purposes of collecting from the issuers.

Explanation of Provision

The Act extends the provision of section 6311(b)(2) to include guaranteed drafts of financial institutions other than banks and trust companies. It is expected that the regulations issued under this provision would define "financial institution" to include domestic building and loan associations, mutual savings banks, and credit unions.

Effective Date

This provision became effective on July 18, 1984.

Revenue Effect

This provision will have a negligible revenue effect.

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[47] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 468, H. Rep. No. 98-432, Pt. 2 (March 5, 1984), p. 1558; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 840; S. Prt. 98-169, Vol. I (April 2, 1984), p. 795; and H. Rep. No. 98-861 (June 23, 1984), p. 1123 (Conference Report).

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9. Disclosure of Windfall Profit Tax to State Tax Agencies (sec. 449 of the Act and sec. 6103(d) of the Code)[48]

Prior Law

Prior and present law (sec. 6103(d)(1)) authorizes the disclosure of returns and return information with respect to taxes imposed by chapters 1, 2, 6, 11, 12, 21, 23, 24, 31, 32, 44, 51, and 52 and subchapter D of chapter 36 to the State tax agencies which are principally charged with the primary responsibility for the administration of State tax laws. Prior law does not authorize the Service to disclose windfall profit tax (chapter 45) information to State tax agencies.

Reasons for Change

Congress believed that States should have a means of verifying information reported by oil producers and purchasers, in compliance with State severance tax laws, with information provided by the producers and purchasers to the Internal Revenue Service with respect to the windfall profit tax.

Explanation of Provision

The Act adds the windfall profit tax to the list of tax returns and return information which the Internal Revenue Service may disclose to State tax agencies for purposes of administering State tax laws.

Effective Date

This provision became effective on July 18, 1984.

Revenue Effect

This provision will have no revenue effect.

[48] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 469; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), p. 1559; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 841; S. Prt. 98-169, Vol. I. (April 2, 1984), p. 796; and H. Rep. No. 98-861 (June 23, 1984), p. 1123 (Conference Report).

10. Financial Accounting for the Investment Tax Credit (sec. 450 of the Act and sec. 101(c)(1)(C) of the Revenue Act of 1971)[49]

Prior Law

Prior to 1971, the Accounting Principles Board (APB) and the SEC permitted the use of either the "direct flow-through" method of accounting for the investment tax credit (which provides that the full amount of the credit reduces tax expense in the year earned) or the "deferral" method (which provides that the credit reduces tax expense ratably over the life of the asset involved). Because the flow-through method immediately increases earnings, most companies adopted it. However, in the view of some, the deferral method is the more theoretically correct method because it treats the credit in accordance with its true economic effect, i.e., as a subsidy that reduces the cost of the asset acquired.

In 1971, the APB tentatively concluded that permitting a choice of methods was inappropriate and issued a discussion draft statement suggesting that only the deferral method would be accepted. In connection with the restoration of the credit in the Revenue Act of 1971, Congress enacted a provision (section 101(c)(1)(A) of the Revenue Act of 1971) that limits the ability of any Federal agency to compel with respect to any taxpayer a particular method of accounting for the credit. Section 101(c)(1)(C) of that Act required a taxpayer to use the same method of accounting for the credit in all reports subject to the jurisdiction of any Federal agency unless the Treasury Department approves a change to another method. Subsequently, the APB revoked its discussion draft.

Reasons for Change

Congress noted that the Revenue Act of 1971 provided no standards for the Treasury to use in acting upon requests to change a method of financial accounting for the credit. It also noted that no penalties were provided for failing to obtain Treasury approval. Congress did not desire that the Treasury consume further manpower in acting upon requests under such circumstances; neither was Congress prepared to provide standards or propose penalties.

Explanation of Provision

The Act repeals section 101(c)(1)(C) of the Revenue Act of 1971.

[49] For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 838; S. Prt. 98-169, Vol. I (April 2, 1984), p. 793; and H. Rep. No. 98-861 (June 23, 1984), p. 1126 (Conference Report).

Effective Date

The provision is effective as of the effective date of section 101(c)(1)(C) of the Revenue Act of 1971.

Revenue Effect

The provision will have no effect on revenues.

11. Provisions Relating to Distilled Spirits

a. Repeal of occupational tax on manufacturers of stills and condensers (sec. 451 of the Act and secs. 5101, 5105 and 5179 of the Code)[50]

Prior Law

Prior law (sec. 5101) imposed an occupational tax of $55 per year on manufacturers of stills. In addition, a tax of $22 was imposed on each still (or condenser to be used in distilling) manufactured. An exemption from these taxes was provided for stills manufactured by a proprietor of a distilled spirits plant exclusively for use in the proprietor's plant.

Under prior law, a manufacturer of stills was required to notify the Treasury Department, in writing, of the removal of a still, boiler, or other distilling vessel from the place of manufacture and the person and place to which it was being moved (sec. 5105). The still (or other distilling apparatus) could be set up only upon receipt of a written permit from the Treasury Department. Further, every person having possession or control over a still was required to register with Treasury immediately after setting up the still (sec. 5179).

Reasons for Change

Congress determined that the costs of administering the taxes on still manufacturers outweighed the revenues derived from these taxes (less than $10,000 per year). The Act therefore repeals these taxes.

Congress also reviewed the notice requirement for removal of stills and other distilling apparatus and believed that this requirement serves a valid administrative purpose relating to the collection of alcohol taxes generally. However, in recognition of the costs both to the Treasury Department and to private businesses of administering these provisions, Congress believed that Treasury should be entitled to apply this requirement at its own discretion. Accordingly, the Act replaces the existing statutory notice requirement with a provision allowing the Treasury to require notice pursuant to regulations.

Congress understood that, because the excise tax liability for distilled spirits attaches upon production, Treasury must be aware of the location of stills and other distilling apparatus in order to properly administer these taxes. Congress determined, therefore, that

[50] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 470; H. Rep. No. 98-432, Pt 2 (March 5, 1984), p. 1560; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 843; S. Prt. 98-169, Vol. I (April 2, 1984), p. 798, and H Rep. No. 98-861 (June 23, 1984), p. 1123 (Conference Report).

the mandatory requirement of registration immediately after setting up a still should be retained .

Explanation of Provision

The Act repeals both the $55 per year occupational tax on manufacturers of stills and the additional $22 tax for each still.

The Act repeals the mandatory requirement of notice of manufacture and removal of a still and the requirement of permission prior to set up of a still. In their place, the Act provides that the Treasury Department may, pursuant to regulations, require manufacturers of stills, boilers, or other distilling facilities to give notice before removal of the facility. This notice (if required) would set forth the capacity of the facility, the time of removal, and the person by whom the facility is to be used. The Act retains the requirement of registration by the still user after setting up the facility.

Effective Date

The provision became effective on November 1, 1984.

Revenue Effect

This provision will have a negligible revenue effect.

b. Drawback of taxes on spirits used for food or medicinal purposes (sec. 452 of the Act and sec. 5134 of the Code)[51]

Prior Law

Prior law imposed an excise tax of $10.50 per proof gallon on distilled spirits (sec. 5001). Drawback (refund) of the taxes paid on distilled spirits used in the manufacture of food products, flavorings, or medicines which are unfit for beverage purposes was allowed (sec. 5134). A drawback was claimed by submission of a properly executed claim by a qualifying user of the spirits.

Taxpayers claiming a drawback of distilled spirits taxes were required to keep books and records necessary to establish that the spirits were used for food, medicinal, or other nonbeverage purposes (sec. 5132). Treasury Department regulations required that supporting data be maintained by the manufacturer, including quantitative formulae which had to be filed prior to or at the time of manufacture (27 CFR 197.95). Failure to comply with any of these requirements resulted in a denial of the claim. For example, even a minor deviation from a previously filed formula could result in denial of a substantial drawback claim.

Reasons for Change

Congress believed that failure to comply with various technical aspects of the drawback provisions should not result in denial of

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[51] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 471; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), p. 1561; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 844; S. Prt. 98-169, Vol. I (April 2, 1984), p. 801, and H. Rep. No. 98-861 (June 23, 1984), p. 1124 (Conference Report).

the taxpayer's claim. Accordingly, the Act provides that a penalty is to be imposed for such violations, in lieu of denying the claim. This is consistent with the treatment under the Internal Revenue Code of other nonfraudulent regulatory violations.

Explanation of Provision

The Act provides that the Treasury Department may not deny a drawback claim because of failure to comply with laws or regulations, if it is established to Treasury's satisfaction that the distilled spirits have been used for food, medicinal, or other nonbeverage purposes. In lieu of denial, the claimant will be liable for a $1,000 penalty for each failure to comply with the applicable laws or regulations (unless it is shown that the failure was due to reasonable cause). The aggregate amount of the penalties may not exceed the amount of the taxpayer's drawback claim.

Congress intended that, if nonbeverage products deviate from previously filed formulae, the determination of whether a failure to comply with the regulations has occurred will be made with respect to each separate product reflected in a drawback claim. For example, if a manufacturer of two distinct flavors or extracts submitted a drawback claim, and some portion of each flavor deviated from the previously filed formula, the claimant would be liable for a penalty of $2,000 (unless the failure to comply was due to reasonable cause).

Effective Date

The provision became effective on November 1, 1984.

Revenue Effect

This provision is estimated to reduce revenues by less than $1 million annually.

c. Disclosure of alcohol fuels producers to administrators of State alcohol laws (sec. 453 of the Act and sec. 6103 of the Code)[52]

Prior Law

The Treasury Department generally is prohibited from disclosing individual tax return information (including the identity of taxpayers), without the taxpayer's consent, except under certain specified circumstances. In general, disclosure is permitted where necessary for the enforcement or administration of the tax laws, in connection with criminal investigations, and in certain cases involving an overriding public policy interest (e.g., disclosure to state child support enforcement agencies). Disclosure also may be made to other Federal agencies for certain specified purposes.

Under prior law (sec. 6103(d)), tax return information could be disclosed to State agencies charged with responsibility for adminis-

[52] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 472; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), p. 1562; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 845; S. Prt. 98-169, Vol. I (April 2, 1984), p. 802, and H. Rep. No. 98-861 (June 23, 1984), p. 1124 (Conference Report).

tration of State tax laws. Such disclosure could be made only to the extent necessary for the administration of State tax laws.

The names and addresses of distillers who produce alcohol for fuel use qualify as tax return information. Accordingly, this information may be disclosed only under the circumstances specified by the Code (e.g., to State tax agencies).

Reasons for Change

Congress believed that disclosure of the identity of alcohol fuels producers is useful to State governments in monitoring the production of alcohol fuels. Such disclosure is consistent with the general Federal policy of encouraging the development and use of these fuels. However, Congress believed that this disclosure should be subject to reasonable safeguards to preserve the confidentiality of the information.

Explanation of Provisions

The Act allows the Treasury Department to disclose the names, addresses, and business locations of persons producing alcohol for fuel use to State agencies charged with responsibility for the administration of State alcohol laws. The information is to be disclosed solely for use in the administration of State alcohol laws.

The disclosure allowed by the Act is subject to the safeguards provided by the Code (sec. 6103(p)(4)) for disclosure to other Federal and State agencies. These safeguards are designed to preserve the confidentiality of information once it has been provided to another agency.[53]

Effective Date

The provision became effective on November 1, 1984.

Revenue Effect

This provision will have no revenue effect.

d. Elimination of Government-supplied strip stamps for distilled spirits containers (sec. 454 of the Act and secs. 5205, 5604, and new sec. 5301(d) of the Code)[54]

Prior Law

Prior law (sec. 5205) required distilled spirits containers transported or sold in the United States to bear a stamp indicating that the Federal excise tax on the spirits had been paid. Strip stamps which satisfy this requirement were printed by the Bureau of En-

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[53] Sec. 6103(p)(4) requires, *inter alia*, that an agency receiving return information must (1) establish and maintain a permanent system of standardized records with respect to requests for information made or received by the agency, (2) restrict access to tax return information to those who require it, and (3) provide such other safeguards as the Treasury Department may deem appropriate. The agency is required to report to Treasury concerning its procedures for preserving confidentiality.

[54] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 473; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), p. 1563; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 846; S. Prt. 98-169, Vol. I (April 2, 1984), p. 804; and H. Rept. No. 98-861 (June 23, 1984), p. 1125 (Conference Report).

graving and Printing at an estimated cost of $1.7 million per year and were distributed to distillers and bottlers free of charge.[55] Although regulations first effective in 1980[56] authorized the use of alternate methods of indicating payment of tax, most distillers continued to use the Government-supplied strip stamps on distilled spirits containers. Government-supplied strip stamps generally had to be broken in order to open a distilled spirits container. Thus, the stamps acted as closure devices for the containers.

For many years, strip stamps were numbered and controlled by employees of the Treasury Department's Bureau of Alcohol, Tobacco, and Firearms. The stamps were applied after these employees had determined the appropriate tax and had been satisfied that the spirits had been bottled in conformity with Federal laws. However, the Distilled Spirits Tax Revision Act of 1979 (P.L. 96-39) significantly modified the method of determining the tax on distilled spirits. The new method providing for determination of tax when spirits are withdrawn from bond eliminated the need for Federal employees to be present at distilled spirits plants to regulate operations and to determine the tax before bottling. Consequently, after enactment of the 1979 Act, strip stamps were provided to distillers and, in most cases, were placed on distilled spirits containers before the tax had been determined.

Reasons for Change

Congress understood that, pursuant to the Distilled Spirits Tax Revision Act of 1979, the Treasury Department eliminated regular on-site supervision of distilled spirits plants and now concentrates its effort on an examination-based approach to tax compliance. Congress further understood that, because strip stamps generally were placed on distilled spirits containers before the tax was determined, the stamps no longer provided evidence of payment of the tax. Finally, Congress believed that the cost of supplying strip stamps was not justified since the stamps no longer serve tax compliance purpose.

Explanation of Provision

The Act repeals the strip stamp requirement for distilled spirits containers (sec. 5205) and associated penalty provisions (sec. 5604). However, the Act requires that distilled spirits containers, on determination of tax, bear a closure or other device which is designed to require breaking in order to gain access to the contents of the container (new sec. 5301(d)). The provision applies to domestically produced and imported distilled spirits. As under prior law, closure devices are not required for containers having a capacity in excess of one wine gallon.

Congress intended that government-supplied strip stamps may be affixed to containers of distilled spirits only until July 1, 1985. However, in cases where strip stamps are affixed to containers of distilled spirits before that date, the containers may be imported or

[55] U.S. General Accounting Office, "The Federal Government Can Save $1.7 Million Annually by Eliminating Strip Stamps" (GAO Report GGD-82-60, May 7, 1982).
[56] 27 CFR 19.663.

brought into the United States, released from Customs custody, or withdrawn from internal revenue bond with the stamps affixed. In such cases, Congress intended that the Federal strip stamps on such containers be considered to meet the Act's requirement for an antitampering device on distilled spirits containers.

Effective Date

This provision will be effective on July 1, 1985.

Revenue Effect

The provision will have no effect on budget receipts. However, the elimination of strip stamps will save the Federal Government an estimated $1.7 million per year in printing costs.

e. Removal of distilled spirits for use in production of certain nonbeverage wine without payment of tax (sec. 455 of the Act and sec. 5214 of the Code)[57]

Prior Law

An excise tax equal to $10.50 ($12.50 after September 30, 1985) per proof gallon is imposed on distilled spirits produced in or imported into the United States (sec. 5001). This tax is determined upon removal of the distilled spirits from the distilled spirits plant or customs custody (sec. 5006). In certain cases, distilled spirits may be removed without payment of tax (sec. 5214). Prior law did not permit removal without payment of tax of distilled spirits other than wine spirits or brandy for use in wine production. Therefore, the tax on distilled spirits (other than brandy or wine spirits) used in a nonbeverage wine product was required to be paid upon removal of the spirits from bonded premises and a claim for refund made.

Reasons for Change

Congress determined that U.S. producers of nonbeverage wine products such as cooking wine should be permitted to use any type of distilled spirits in the production of those products without the necessity of paying tax on removal of the spirits and then claiming a refund. This treatment will enable U.S. producers of these products to compete more effectively with producers of similar imported goods.

Explanation of Provision

The Act expands the circumstances under which distilled spirits may be removed from a distilled spirits plant without payment of tax to permit removal of any type of distilled spirits for use in producing nonbeverage wine products (e.g., cooking wine). This provi-

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[57] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 809; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), p. 1754; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 848; S. Prt. 98-169, Vol. I (April 2, 1984), p. 809; and H. Rep. No. 98-861 (June 23, 1984), p. 1126 (Conference Report).

sion does not permit the tax-free use of wine products thereby produced in any beverage product.

Effective Date

This provision became effective on July 18, 1984.

Revenue Effect

This provision is estimated to reduce fiscal year budget receipts by less than $1 million annually.

E. Tax Court Provisions

1. Increase in Jurisdictional Limit for Small Tax Cases (sec. 461 of the Act and sec. 7463 of the Code)[58]

Prior Law

Under prior and present law, taxpayers using the "small tax case" procedure may appear pro se or be represented by any person admitted to practice before the Tax Court. Small tax case proceedings are generally conducted in a more informal atmosphere, and the Court's opinion is final and may not be appealed. Under prior law, small tax cases were cases involving $5,000 or less for any one taxable year or period.

Reasons for Change

Congress believed that Tax Court cases could be handled more expeditiously if the dollar limit on the cases in which the taxpayer may elect the small tax case procedures were raised.

Explanation of Provision

The Act raises the dollar limit in small tax cases to $10,000.

Effective Date

The provision became effective on July 18, 1984.

[58] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 475; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), p. 1566; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 156; S. Prt. 98-169, Vol. I (April 2, 1984), p. 449; and H. Rep. No. 98-861 (June 23, 1984), p. 1127 (Conference Report).

2. Survivor Annuities (sec. 462 of the Act and sec. 7448 of the Code)[59]

Prior Law

Prior and present law provides that, under the survivors annuity plan for Tax Court judges, if a judge is survived by a spouse and a dependent child or children, an annuity equal to one-half the annuity of the surviving spouse is payable to each child. Under prior law, that amount could not exceed the lesser of $900 per year divided by the number of such children or $360 per year. Under prior and present law, if a judge leaves no surviving spouse, but leaves a surviving dependent child or children, the annuity payable to each child is equal to the annuity to which a surviving spouse would have been entitled. Under prior law, that amount could not exceed $480 per year.

These maximum annuity amounts had not been changed since 1961, although the limits for annuities to surviving children of other Federal judges had been increased.

Reasons for Change

Congress believed that the annuities for surviving children of Tax Court judges should be increased to reflect cost of living changes since the limits were set.

Explanation of Provision

Under the Act, the maximum annuities receivable by surviving children of a deceased Tax Court judge in the case where the judge also leaves a surviving spouse will be increased from $900 per year per family ($360 per child) to $4,644 per year per family ($1,548 per child). The comparable amounts for surviving dependent children where the judge leaves no surviving spouse will also be increased to a maximum annuity not in excess of $5,580 per year per family, or $1,860 per child, whichever is less.

These maximum limits are equal to those currently in effect for other Federal judges.

Effective Date

This provision is effective for annuities payable for months after July 1984.

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[59] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 476; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), p. 1567; and H. Rep. No. 98-861 (June 23, 1984), p. 1127 (Conference Report).

3. Assignment of Proceedings (sec. 463 of the Act and sec. 7456 of the Code)[60]

Prior Law

Prior and present law (sec. 7456(d)) provides that the Chief Judge of the Tax Court may assign to the Court's commissioners for hearing and decision any declaratory judgment proceeding, any small tax case proceeding, and any other proceeding where the amount in dispute does not exceed $5,000, subject to such review as the Court may provide.

Reasons for Change

Congress wished to clarify that additional proceedings may be assigned to Commissioners so long as a Tax Court judge must enter the decision.

Explanation of Provision

A technical change is made to allow the Chief Judge of the Tax Court to assign any proceeding to a special trial judge for hearing and to write proposed opinions, subject to review and final decision by a Tax Court judge, regardless of the amount in issue. However, special trial judges will not be authorized to enter decisions in this latter category of cases.

Effective Date

The provision is effective as if enacted as part of the Miscellaneous Revenue Act of 1982.

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[60] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 477; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), p. 1568; and H. Rep. No. 98-861 (June 23, 1984), p. 1127 (Conference Report).

4. Special Trial Judges (sec. 464 of the Act and sec. 7456 of the Code)[61]

Prior Law

The Chief Judge of the Tax Court was authorized to appoint "commissioners" to hear small tax cases and declaratory judgment actions. The commissioners must proceed under rules promulgated by the Court.

Reasons for Change

The Congress believed that the title of the commissioners should be changed to "special trial judge," to better describe their job position.

Explanation of Provision

The title of Tax Court "commissioner" is changed to "special trial judge."

Effective Date

The provision became effective on July 18, 1984.

[61] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 478; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), p. 1569; and H. Rep. No. 98-861 (June 23, 1984), p. 1127 (Conference Report).

5. Publicity of Tax Court Proceedings (sec. 465 of the Act and sec. 7461 of the Code)[62]

Prior Law

Under prior and present law, all reports of the Tax Court and all evidence received by the Court are open to public inspection, except that after its decision in a case has become final, the Court may permit the withdrawal of documents from the record or make such other disposition thereof as it deems advisable.

Rule 103(a) of the Tax Court's Rules of Practice and Procedure provides that the Court may make any order which justice requires to protect a party or other person from annoyance, embarrassment, oppression, or undue burden or expense, including an order requiring that a deposition or other written materials be placed under seal, that a trade secret or other information not be disclosed or be disclosed only in a designated way, or that documents or information be filed in sealed envelopes to be opened only as directed by the Court.

Reasons for Change

Congress wished to clarify that the Tax Court may prevent disclosure of confidential information.

Explanation of Provision

The Act clarifies that the Tax Court may take any action necessary to prevent the disclosure of trade secrets and other confidential information.

Effective Date

The provision became effective on July 18, 1984.

6. Revenue Effect of Tax Court Provisions

The provisions relating to the Tax Court will increase budget outlays by a negligible amount.

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[62] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 479; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), p. 1570; and H. Rep. No. 98-861 (June 23, 1984), p. 1128 (Conference Report).

F. Simplification of Income Tax Credits (secs. 471-475 of the Act and secs. 21-53 of the Code)[63]

Prior Law

Prior law provided a series of nonrefundable income tax credits which were allowable to reduce a taxpayer's tax liability. The credits had been added to the Internal Revenue Code over the years on an ad hoc basis, and previously the various credits were allowable against tax in the chronological order they were added to the Code. This resulted in several effects which probably were not intended. For example, certain credits for which no carryover was provided became unusable while a lower-numbered credit for which a carryover is provided was used up. If the order had been reversed, a different result would have occurred.

Differences existed in the manner the various business credits could be used to reduce tax liability. First, credit carryovers were usable in different chronological orders—the investment credits were used on an earliest year first (FIFO) basis, and the other credits were used on a current year first basis. Next, the tax liability limitations for the different business credits differed. The investment tax credit (other than the energy tax credit) could be used to reduce 100 percent of the first $25,000 of tax and 85 percent of the tax in excess of $25,000. The targeted jobs credit could be used against 90 percent of tax liability; the ESOP credit could reduce 100 percent of the first $25,000 of tax liability and 90 percent of the tax in excess of $25,000. The remaining business credits, including the energy tax credit, could reduce 100 percent of tax liability. In each case, tax liability meant the income tax imposed reduced by lower numbered credits. Finally, the investment credit, targeted jobs credit, research activities credit, and ESOP credit had a 3-year carryback period whereas the alcohol fuels credit had no carryback period; these credits had a 15-year carryforward period.

Reasons for Change

The Congress believed that the prior income tax credit mechanism was complex and, at times, not rationally structured. The Congress believed that the computations of these credits should be rationalized and simplified. This can be accomplished by allowing the personal income tax credits to be placed first in order, and by combining the business credits into one credit with uniform carryover and tax liability limitations. The Congress also believed tax-

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[63] For legislative background of the provision, see: H.R 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, secs 481-486; H Rep No. 98-432, Pt. 2 (March 5, 1984), pp. 1573-1574; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, secs. 850-854; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 810-811; H. Rep. No. 98-861 (June 23, 1984), pp. 1128-1129 (Conference Report).

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payers should generally not be able to eliminate their entire tax liability by use of the credits which provide business incentives. However, the Congress believed that the research credit should not be restructured at this time.

The Congress recognized that the foreign tax credit is different in purpose and concept from the personal credits and the incentive credits, and should not be included in such a uniform credit.

Explanation of Provision

Under the Act, the personal income tax credits—the dependent care credit, credit for elderly and disabled, residential energy credit, political contribution credit and the mortgage certificate credit—will be allowable against tax before all other credits. Next the foreign tax credit, credit for clinical testing of certain drugs, and fuel production credit will be allowable against tax under the conditions of prior law.[64]

The business income tax credits—the investment tax credit (both the regular and the energy credits), targeted jobs credit, alcohol fuels credit, and ESOP credit—will be combined into one general business credit. This credit will be allowable against 100 percent of the first $25,000 of tax liability and 85 percent of the remaining tax liability. Tax liability generally means the income tax imposed (excluding certain enumerated taxes) reduced by other nonrefundable credits. The credit will be used on a FIFO basis with a 3-year carryback and 15-year carryforward period. The research activities credit will continue to be allowed against 100 percent of a taxpayer's tax liability.

Effective Date

This provision applies to taxable years beginning after 1983. Unexpired credits from each pre-1984 taxable year will be combined into a business credit carryforward from that earlier year to be carried to post-1983 years (for a period not to exceed 15 years from the year of the original credit). Thus, for example, where a taxpayer made an investment entitling it to claim the employee plan percentage, the taxpayer may continue to make an election to claim that percentage as a carryforward from the earlier year under the rules in effect for the year the investment was made.

Carrybacks of the general business credit to pre-1984 years are allowed.

Revenue Effect

The provision is estimated to increase revenues by $100 million in fiscal 1984, $183 million in fiscal 1985, $179 million in fiscal 1986, $194 million in fiscal 1987, $110 million in fiscal 1988 and $25 million in fiscal year 1989.

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[64] A conforming amendment to section 55(c)(3)(A) inadvertently changed the credit carryover and carryback rules. A technical correction retaining the principles of prior law is anticipated.

G. Miscellaneous Tax Provisions

1. Preferred Stock Eligible for Small Business Corporation Stock Treatment (sec. 481 of the Act and sec. 1244 of the Code)[65]

Prior Law

Under prior and present law, gain or loss on the disposition of a capital asset (such as corporate stock held for investment purposes) is generally treated as capital gain or loss. A capital loss sustained by an individual first offsets any capital gain. Any excess capital losses offsets up to $3,000 of ordinary income.

Ordinary loss treatment, rather than capital loss treatment, is provided in certain cases for small business corporation stock (section 1244 stock) which was disposed of at a loss. This special treatment is accorded only to individual shareholders to whom the stock was originally issued, and to individuals who were partners in a partnership at the time the partnership acquired the stock from an issuing small business corporation and who share in a loss sustained by the partnership on the section 1244 stock.

The maximum amount of ordinary loss from the disposition of section 1244 stock that may be claimed in any taxable year is limited to $50,000 ($100,000 in the case of married taxpayers filing a joint return).

For stock to qualify as section 1244 stock, under prior law, the following requirements must have been met: (1) the stock must be common stock; (2) the corporation issuing the stock must be a domestic corporation; (3) the equity capital of the corporation may not exceed $1,000,000; (4) the stock must be issued for money or other property, subject to certain exceptions; and (5) the corporation must be engaged in the active conduct of a trade or business.

Reasons for Change

The Congress believed that to encourage new venture capital, an ordinary loss deduction should be available on preferred stock, as well as common stock, of small business corporations.

Explanation of Provision

Under the Act, the ordinary loss provisions of section 1244 will be extended to losses on preferred stock of small business corporations. All restrictions applicable under prior law to losses on common stock will apply to losses on preferred stock.

[65] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 492; H Rep No 98-432, Pt. 2 (March 5, 1984), p. 1581; and H. Rep. No. 98-861 (June 23, 1984), p. 1129 (Conference Report).

Effective Date

The provision applies to stock issued after July 18, 1984.

Revenue Effect

The provision is estimated to reduce budget receipts by less than $5 million annually.

2. Medical Expense Deduction for Certain Lodging (sec. 482 of the Act and sec. 213 of the Code)[66]

Prior Law

Individuals who itemize deductions may deduct expenses paid during the taxable year, not reimbursed by insurance or otherwise, for medical care of the taxpayer and the taxpayer's spouse and dependents, to the extent that such expenses exceed five percent of adjusted gross income (sec. 213). The term medical care is defined in the statute to include amounts paid for: (1) the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body; (2) transportation primarily for and essential to such medical care; and (3) insurance covering medical care. Under prior law, medical expenses eligible for the deduction did not include any costs of lodging incurred while away from home to obtain medical care, other than such costs incurred during hospitalization.

Reasons for Change

The Congress was aware of instances in which an individual must travel away from home to receive medical care. In many such cases, this is because specialized care for a particular disease is not available near home, or because better care is available elsewhere. Also, the Congress was aware that in some cases the patient is unable to travel alone and must be accompanied by another person (for example, where an infant is accompanied by her mother).

In some instances, as in the case of some chemotherapy treatment for cancer patients, the treatment away from home can be given in a hospital or hospital-related facility on an outpatient basis, which generally is less expensive than treatment on an inpatient basis in a hospital. While the expenses of a hospital stay are deductible, under prior law expenses of lodging incurred away from home during outpatient medical treatment were not eligible for the deduction. The Congress concluded that a limited medical expense deduction for lodging expenses should be allowed in appropriate cases.

The Congress was concerned, however, that the new provision could be difficult for the Internal Revenue Service to administer, and that some taxpayers might seek to convert nondeductible costs of lodging while on a vacation trip into deductible costs of lodging for medical care. The provision expressly disallows deducting any amount for lodging expenses if there is any significant element of

[66] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 493; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1583-1584; and H. Rep. No. 98-861 (June 23, 1984), pp. 1129-1130 (Conference Report).

personal pleasure, recreation, or vacation in the travel away from home. In addition, the Congress believed that placing a per-diem cap on the amount that is deductible for away-from-home lodging will be useful in alleviating these concerns. Finally, the taxpayer must substantiate any deduction claimed for lodging expenses under the provision in the manner and to the extent as the Treasury may prescribe by regulations.

Explanation of Provision

Under the Act, the definition of medical care set forth in section 213(d) is broadened to include amounts paid for lodging while away from home under circumstances in which such lodging is primarily for and essential to medical care provided by a physician in a licensed hospital (or in a medical care facility which is a hospital-related facility or the equivalent of a licensed hospital). Medical care facilities described in this provision include out-patient clinics which provide substantial services similar to those provided by hospitals (e.g., the Mayo Clinic).

No deduction is allowed for any amount paid for lodging if the lodging is lavish or extravagant under the circumstances. Further, no deduction is allowed for any amount of lodging expenses if there is any significant element of personal pleasure, recreation, or vacation in the travel away from home, even though part of the time spent away from home is devoted exclusively to obtaining medical care. The provision does not expand section 213(d) to cover any category of expenses (such as food) other than lodging expenses.

The Congress intended that if the away-from-home lodging expenses of a spouse or dependent (as defined in sec. 152) of the taxpayer are deductible by the taxpayer as medical expenses under the Act, and if such spouse or dependent is unable to travel and reside away from home for such medical care purposes without the accompaniment of the taxpayer, then the away-from-home lodging expenses of the taxpayer while accompanying the taxpayer's spouse or dependent for such medical care purposes are deductible as medical expenses pursuant to the provision.

The amount of the deduction is subject to a limitation of $50 per night for each person whose lodging expenses are deductible under the provision; i.e., the deduction per eligible person equals the lower of the actual lodging expenses or $50 per night. Thus, if the taxpayer accompanies his or her infant child away from home for outpatient medical care at a hospital, and if the lodging expenses of both the taxpayer and his or her child are deductible under the provision, then the taxpayer could deduct the actual lodging expenses up to an aggregate total of $100 per night.

As in the case of other types of medical expenses eligible for deduction under section 213, the taxpayer must substantiate any deduction claimed for lodging expenses under the provision in the manner and to the extent as the Treasury Department may prescribe by regulations (see Regs. sec. 1.213-1(h)).

Effective Date

The provision applies to taxable years beginning after December 31, 1983.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by $1 million in 1984, $7 million in 1985, $10 million in 1986, $10 million in 1987, $11 million in 1988, and $12 million in 1989.

H. Repeal of Certain Obsolete Provisions (Deadwood)

1. Termination of Rules Relating to Qualified Bond Purchase Plans and Retirement Bonds (sec. 491 of the Act and secs. 405 and 409 of the Code)[67]

Prior Law

Qualified bond purchase plans

Under prior law, a bond purchase plan maintained by an employer and funded through the purchase of certain Federal bonds was treated as a qualified plan if it met specified requirements.[68] Bonds purchased for a plan participant were issued in the name of the participant (whose rights under the bond are nonforfeitable at all times). The terms of the bonds provided for payment of interest, or investment yield, only upon redemption and provided for cessation of interest accruals, or investment yield, not later than five years after the death of the individual in whose name the bonds were purchased. Moreover, no amounts were included in an individual's gross income until the bonds are redeemed, which could not occur until the named individual died, became disabled, or attained age 59½.

Effective for redemptions made after August 13, 1981, all or a portion of the redemption proceeds in excess of amounts contributed by the participant can be rolled over, tax-free, to an individual retirement account or annuity (an IRA), if the rollover is made within 60 days after the individual received the proceeds of the redemption. If no rollover is made, the income portion of the redemption proceeds are includible in gross income. The proceeds are not eligible for the long-term capital gains or 10-year income averaging treatment available for certain lump-sum distributions from tax-qualified pension, profit-sharing, or stock bonus plans. The bonds were eligible, however, for certain estate tax and gift tax exclusions provided to tax-qualified plans.[69]

Individual retirement bonds

Under prior law, an individual was allowed an annual deduction for contributions to purchase a qualified retirement bond.[70] The

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[67] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 497; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1586-1588; and H. Rep. No. 98-861 (June 23, 1984), p. 1130 (Conference Report).

[68] Sec. 405(a)(1). The plan must have met the requirements of section 401(a) relating to coverage and discrimination (sec. 401(a)(3), (4), (5) and (6)), vesting (sec. 401(a)(7), (8), and (9)), limitations (401(a)(16)), and, if it covered a self-employed individual, was subject to rules relating to distributions and self-employed individuals (sec. 401(a)(9) and (10)).

[69] Treas. Reg. secs. 20.2039-2(b) and 25.2517-1(b).

[70] Sec. 219(a).

deduction was generally limited to the lesser of $2,000 or 100 percent of compensation (earned income in the case of a self-employed individual). A qualified retirement bond was a bond issued under the Second Liberty Bond Act that accumulated interest until the time of redemption. The bonds were issued in the name of the individual (the registered owner) on whose behalf they were purchased and were not transferable.

When the bonds are redeemed, the full proceeds of the bonds, including interest earned, are included in the individual's gross income unless the proceeds are rolled over, tax-free, to an IRA.[71] If a bond is redeemed before the registered owner attains age 59½, dies, or becomes disabled, a 10-percent additional income tax is imposed on the redemption proceeds. No deduction was allowed with respect to a bond that was redeemed within 12 months of the date of purchase, and the proceeds of such a bond were not includible in gross income.

A qualified retirement bond ceases to bear interest in the year in which the registered owner attains age 70½ and the value of the bond is includible in the registered owner's gross income in that year, whether or not the bond is redeemed. If the registered owner dies before age 70½ or before the bond is redeemed, the bond ceases to bear interest five years after the registered owner's death or the date the registered owner would have attained age 70½, if earlier.

Redemption proceeds from qualified retirement bonds are eligible for tax-free rollovers to individual retirement accounts or annuities. Additionally, the bonds were eligible for certain estate tax and gift tax exclusions.[72]

Termination of sales

In a news release dated April 27, 1982, the Treasury Department announced that sales of bonds for qualified bond purchase plans and of individual retirement bonds would be terminated effective April 30, 1982. The Treasury Department indicated that sales of the bonds in recent months had been negligible. Bonds issued prior to April 30, 1982, continued to be subject to the terms and conditions in effect when they were issued.

Reasons for Change

Because new bonds cannot be purchased, the retirement plans of prior bondholders may be disrupted unless the proceeds of the bonds can be reinvested in other retirement arrangements. The Congress believed that it is appropriate to permit bonds purchased under qualified bond purchase plans to be redeemed before the registered owner attains age 59½. In addition, in order to provide greater investment flexibility to a bondholder (under a qualified bond purchase plan) who also participates in a qualified plan, the Congress believed that the rollover of redemption proceeds to a qualified plan should be permitted.

[71] Sec. 409.
[72] Secs. 2039 and 2517(a).

Explanation of Provision

Effective with respect to obligations issued after December 31, 1983, the Act repeals sections 405 and 409 of the Internal Revenue Code, relating to qualified bond purchase plans and individual retirement bonds. In general, the redemption, taxation, and rollover consequences of previously issued obligations will be determined under the rules of sections 405 and 409, as in effect prior to repeal. Notwithstanding the prior law rules of section 405 and the terms of any bond issued under a qualified bond purchase plan, the Act permits an individual to redeem a bond at any time even though the individual has not attained age 59½. Of course, the redemption proceeds in excess of employee contributions will be includible in gross income unless a qualifying rollover is made. As under prior law, the proceeds are not eligible for the long-term capital gains or 10-year income averaging treatment available for certain lump-sum distributions from qualified plans.

In addition, the Act provides that the redemption proceeds of bonds held under a qualified bond purchase plan may be rolled over, tax-free, to a qualified plan. If such a rollover is made, however, the rollover amounts (1) must be subject to separate accounting under the recipient plan, and (2) are not eligible for capital gain or 10-year income averaging treatment, or the special treatment of net unrealized appreciation from employer securities.

Effective Date

The provision generally applies to obligations issued after December 31, 1983.

The provision relating to rollovers applies to redemptions made after July 18, 1984.

Revenue Effect

This provision will have no revenue effect.

2. Repeal of Section 1251 (relating to gains from disposition of certain property used in farming) (sec. 492 of the Act and sec. 1251 of the Code)[73]

Prior Law

Section 1251 was enacted in 1969 to prevent certain high income taxpayers from using farm losses to defer their non-farm income and then later obtaining capital gains on the disposition of their farm property. The Tax Reform Act of 1976 terminated these provisions with respect to farm losses incurred after 1975.

Reasons for Change

The Congress believes that section 1251 should be repealed as deadwood since it no longer serves a meaningful function.

Explanation of Provision

The Act repeals section 1251, as deadwood.

Effective Date

The repeal of section 1251 will be effective for taxable years beginning after 1983.

Revenue Effect

This provision will have no revenue effect.

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[73] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 498; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), p. 1589; and H. Rep. No. 98-861 (June 23, 1984), p. 1130 (Conference Report).

TITLE V—EMPLOYEE BENEFIT PROVISIONS

A. Welfare Benefit Plans

1. Treatment of Funded Welfare Benefit Plans (sec. 511 of the Act and secs. 419 and 419A of the Code)[1]

Prior Law

The Code generally allows a deduction for ordinary and necessary expenses paid or incurred during a taxable year in carrying on a trade or business, including a reasonable allowance for salaries and other compensation for personal services actually rendered.[2] The deduction for compensation is limited to amounts that constitute reasonable compensation. Treasury regulations provided for the deduction of amounts "paid or accrued within the taxable year for dismissal wages, unemployment benefits, guaranteed annual wages, vacations, or a sickness, accident, hospitalization, medical expense, recreational, welfare, or similar benefit plan . . . if they are ordinary and necessary expenses of the trade or business".[3] Additional limitations and restrictions are provided by other provisions of the Code.[4]

The special deduction-timing rules and rules for measuring deductions that apply to amounts paid under a plan of deferred compensation[5] do not apply to deductions for welfare benefits if those benefits are not regarded as deferred compensation. Neither the Code nor the Treasury regulations provides a definition that clearly distinguishes welfare benefits from deferred compensation. In the past, for example, a plan providing educational benefits to the children of employees was regarded as a plan of deferred compensation and no deductions were allowed for employer contributions to the trust from which such benefits were paid before the benefits were includible in the gross income of the employees.[6] Recently, however, a plan providing educational benefits to employees' children was found to be a welfare plan and the employer was allowed

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[1] For legislative background of the provision, see: committee amendment to H.R. 4170, approved by the House Committee on Ways and Means on March 1, 1984, sec. 111; H. Rep. No. 98-432, Part 2 (March 5, 1984), pp. 1274-81; H. Con. Res. 328, 130 Cong. Rec. (June 29, 1984), H7526-27; and H. Rep. 98-861 (June 23, 1984), pp. 1154-60 (Conference Report).

[2] Sec. 162(a)(1).

[3] Treas. Reg. sec. 1.162-10(a). Treas. Reg. sec. 1.162-10(c) provides, however, that deductions for contributions under any plan deferring the receipt of compensation are governed by section 404.

[4] See, for example, sec. 264 (deductions for certain life insurance premiums are denied), sec. 267 (deductions for certain accrued but unpaid expenses are denied if the expense is payable to a related, cash method person), and sec. 274 (deductions for certain entertainment, amusement, and recreational facilities are denied if the facilities are not primarily for the benefit of employees other than officers, owners, or highly compensated employees).

[5] Sec. 404. A deduction also may be allowed for contributions to provide disability benefits, incidental death benefits, and post-retirement medical benefits under a qualified pension plan.

[6] See, for example, Rev. Rul. 75-488, 1975-2 C.B. 55, and *Citrus Orthopedic Medical Group, Inc.*, 72 T.C. 461 (1979), *Grant-Jacoby, Inc. v. Commissioner*, 73 T.C. 700 (1980).

a current deduction for contributions to the plan.[7] If the rules for determining the amount and timing of deductions for contributions paid to deferred compensation plans did not apply to welfare benefit plans, an employer may have been allowed a deduction for a contribution under a welfare benefit trust before the benefit was actually provided to an employee.

For both cash and accrual method taxpayers, Treasury regulations provide that if an expenditure results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year, such an expenditure may not be deductible, or may be deductible only in part, for the taxable year in which made or incurred.[8] The regulations provide for ratable amortization of such items. For example, if a cash method taxpayer prepays premiums on insurance, then proration of the premiums has generally been required to determine the amount deductible in a particular year.[9] Proration has also been required in the case of life insurance premiums paid by an accrual method taxpayer.[10]

Reasons for Change

The Congress concluded that the prior-law favorable tax treatment of employer contributions to welfare benefit plans, as compared with employer payments of wages and salary, was inappropriate. In addition, the Congress believed that the prior-law rules under which employers could take deductions for plan contributions far in advance of when the benefits were paid allowed excessive tax-free accumulation of funds.

Congressional concern was caused by recent discussion among tax practitioners as to the tax-shelter potential of welfare benefit plans. Commentators pointed out that the combination of advance deductions for contributions and the availability of tax-exemption for certain employee benefit organizations (such as a voluntary employees' beneficiary association or VEBA) provided tax treatment very similar to that provided to qualified pension plans, but with far fewer restrictions. This discussion became considerably more active after the enactment of the pension provisions of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). Prior to that Act, the Congress had been concerned that qualified plans were being used to provide excessive amounts of tax benefits to relatively high-income individuals. Rules were adopted in TEFRA that lowered the dollar limits on the annual contributions that could be made to qualified plans and the benefits that could be paid out of them. In addition, further restrictions on certain plans required increased benefits for rank-and-file employees.

Some articles recommended the use of VEBAs to recoup deductions lost in qualified plans after TEFRA. In one article on the use of employee benefit plans as a tax shelter, an example was given of how a small professional corporation could utilize the tax benefits of a severance pay plan funded by a VEBA. In this example, the employees of the corporation were two doctors ages 50 and 55, with

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[7] *Greensboro Pathology Associates, P.A. v. United States*, 698 F.2d 1196 (Fed. Cir. 1982).
[8] Treas. Reg. sec. 1.461-1(a)(1) and (2).
[9] See Rev. Rul. 70-413, 1970-2 C.B. 103.
[10] *Trinity Construction Co., Inc. v. United States*, 424 F.2d 303 (5th Cir. 1970).

annual salaries of $150,000 and $200,000, respectively, and three other workers, ages 20 to 36, with annual salaries of $10,000 to $18,000. The example indicates that the corporation could have made tax deductible annual contributions to a tax-exempt VEBA of more than $55,000 annually under terms that would make it unlikely that the three lower-paid employees would receive substantial benefits from the plan. Some of this literature also pointed out that a VEBA could be used as a basis for claiming a deduction for the full cost of acquiring ski chalets and yachts for the use of the employees. A direct purchase of the facility by the employer would permit deductions only for the depreciable basis of the property over a period of time, under the accelerated cost recovery system, after it was placed in service.

Thus, the Congress was concerned that substantial advance funding of welfare benefits could ultimately have led to an unacceptable tax burden for many taxpayers who do not participate in these programs. Accordingly, the Congress provided that, as a general matter, employers should not be permitted a current deduction for welfare benefits that may be provided in the future. Instead, the Congress provided that employers should generally be permitted to deduct employer contributions to a welfare benefit fund on the same basis as if the employer had provided the benefits directly to the employees. Further, this provision is consistent with the provision on premature accruals and deferred payments elsewhere in the Act, under which there is a greater degree of matching between the time a payor deducts a payment and the time the payee includes the amount in income. If this provision on funded plans were not also included, employers could have used funded plans to obtain deductions with respect to benefits much earlier than those allowed under other accounting rules.

The Congress recognized that it is appropriate to permit a reasonable level of reserves to accumulate in a welfare benefit plan for certain self-funded insurance-type benefits—life, accident, sickness, disability, severance pay, and supplemental unemployment compensation benefits. Accordingly, although deductions for advance funding already are allowed for disability and post-retirement medical benefits that are part of a qualified plan, the Congress provided that an employer also should be permitted to deduct contributions for funding a limited reserve in a welfare benefit plan for these particular benefits.

Explanation of Provisions

In general

The Act provides additional rules for determining the timing and the amount of an employer's deduction for a contribution to a welfare benefit fund. Under the Act, contributions by an employer to such a fund are not deductible under sections 162 or 212, but if they satisfy the requirements of either of these sections, will be deductible under this provision, only to the extent that they do not exceed the qualified cost of the plan for the taxable year in which paid. The limitation also applies to contributions with respect to independent contractors.

In the case of a fund providing workers' compensation payments, the rules for funded welfare benefit plans apply only with respect to benefits that do not arise under any workers' compensation act. The rules relating to economic performance (sec. 461(h)) apply to deductions with respect to payments that arise under a workers' compensation act.

Welfare benefit fund

In general

Under the Act, a fund is a welfare benefit fund if it is a part of a plan of an employer and if the employer provides a welfare benefit through the fund to an employee or to a beneficiary of an employee. The Act provides that a benefit is a welfare benefit unless (1) it consists of the transfer of certain property that is not provided under an employee benefit plan,[11] (2) it is treated as deferred compensation[12] or (3) it is a vacation pay benefit under a plan of an employer that elects to treat the plan under section 463.[13]

Definition of fund

The Act defines a fund as any tax-exempt social club,[14] voluntary employees' beneficiary association,[15] supplemental unemployment compensation benefit trust,[16] or group legal services organization;[17] any trust, corporation, or other organization not exempt from income tax; and, to the extent provided by Treasury regulations, any account held for an employer by any person. A fund includes a retired life reserve account maintained by an insurance company on behalf of an employer. Further, if an employer contributes amounts to an insurance company for benefits and under that arrangement the employer is entitled to an automatic rebate if the amount paid exceeds benefit claims and is liable if the benefit claims exceed the amount paid, then such contributions are considered to have been made to a welfare benefit fund.

Under the Act, a plan is not to be considered funded merely because the employer has purchased a benefit for employees. For example, a plan under which an employer makes a direct payment to an insurance company to purchase insurance coverage for a year would not be considered to create a fund if, under the arrangement with the insurer, the employer has no claim to a residual asset. An arrangement that is cancellable by the insurer or employer at the end of a policy year with no provision for a rebate or residual liability would not be considered to create a fund merely because the employer's premium for a renewal year reflects experience for an earlier year. On the other hand, if, under the arrangement, the em-

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[11] The timing of the deduction of such a transfer is determined under sec. 83(h).
[12] Sec. 404 (without regard to sec. 404(b)(2)) or 404A.
[13] Section 404 provides deduction rules for domestic plans of deferred compensation and, as amended by the Act, for certain unfunded welfare benefit plans. Sec. 404A provides rules for foreign plans of deferred compensation. Accordingly, except for current compensation and current benefits not provided through a fund, no deduction is to be allowed under secs. 162 or 212 with respect to compensation or benefits except as provided under subchapter D of the Code.
[14] Sec. 501(c)(7).
[15] Sec. 501(c)(9).
[16] Sec. 501(c)(17).
[17] Sec. 501(c)(20).

ployer is entitled to a refund or other payment in the event the arrangement has favorable experience or is not renewed, then the arrangement creates a fund. Further, if an employer makes a direct payment to an insurance company under a plan, pursuant to a "administrative services only" agreement under which the insurance company maintains a separate account to provide benefits, then the plan would be considered to be a funded plan because the premium payment creates a fund from which benefits are to be provided.

The Congress emphasized that regulations relating to the definition of the term "fund" are to carry out the principal purpose of preventing employers from taking deductions for amounts which create an asset of the employer, or taking premature deductions for expenses which have not yet been incurred, by interposing an intermediary organization that holds assets used to provide benefits to the employees of the employer. Thus, under the regulations, a retired life reserve or premium stabilization account ordinarily is to be considered to be a fund or a part of a fund because such an account is maintained for an individual employer and that employer has a determinable right to have the amount in the account applied against the employer's future costs of benefit claims or insurance premiums. Similarly, the regulations are to provide that a fund exists under a premium arrangement in which an employer may, in some cases, pay an insurance company more in a year than the benefit costs incurred in that year if the employer has an unconditional right in a later year to a refund, credit, or additional benefits determined by reference to the excess payments. However, it is intended that Treasury regulations may exclude from the application of these rules a fund under which the residual asset value is immaterial.

In contrast, a fund would not exist under an ordinary disability income policy for which an employer pays a premium so that employees who become disabled in that year may receive benefit payments for the duration of the disability. Under such a policy, the employer has no right to recover any part of the premium payment and the future benefit payments of an employee whose disability occurs during the period for which the premium is paid are not contingent on any further payments by the employer.

Under the Act, at the election of the employer, 2 or more welfare benefit funds of the employer may be treated as a single fund. Under the Act, however, if an employer elects to aggregate 2 plans for deduction purposes, those 2 plans must also be aggregated in determining whether the plans meet nondiscrimination requirements. Under rules similar to the rules applicable to qualified plans, employees of related employers are to be treated as if they were employed by a single employer and leased employees are to be treated as employees of the recipient employer.[18]

Under the Act, if there is no plan but there is a method or arrangement of employer contributions or benefits that has the effect of a plan, then the new rules for funded welfare benefit plans are to apply as if the method or arrangement were a plan. Also, if any

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[18] Sec. 414(b), (c), (m), and (n).

fund would be a welfare benefit fund but for the fact that there is no employee-employer relationship, then the new rules for welfare benefit funds are to apply as if there were such a relationship.

Exception for 10-or-more employer plans

This provision does not apply to deductions for contributions to certain 10-or-more employer plans. A plan is a 10-or-more employer plan if (1) more than one employer contributes to it, (2) no employer is normally required to contribute more than 10 percent of the total contributions required to be contributed under the plan by all employers, and (3) the plan does not maintain experience-rating arrangements with respect to individual employers. Of course, the rules for aggregation of employers apply in determining whether there are 10 or more employers (sec. 414(b), (c), and (m)).

The exclusion is provided because, under such a plan, the relationship of a participating employer to the plan often is similar to the relationship of an insured to an insurer. The Act provides, however, that notwithstanding compliance with the 10-percent rule, and consistent with the definition of the term "fund" (see above), a plan is not exempt from the deduction limits if the liability of any employer who maintains the plan is determined on the basis of experience rating because the employer's interest with respect to such a plan is more similar to the relationship of an employer to a fund than that of an insured to an insurer. In the case of an arrangement under which the liability of one employer is determined on the basis of experience rating and which, if that employer were not maintaining the plan, would otherwise be a 10-or-more employer plan, the arrangement may be considered to consist of one plan maintained by the employer whose liability is experience rated and a separate 10-or-more employer plan maintained by the other employers.

The Act authorizes Treasury regulations under which the percentage (10 percent) may be increased in appropriate cases. For example, a higher percentage could be appropriate in the case of a plan maintained by employers in the construction industry if unusual building activity in the geographic area covered by the plan causes temporary and unusual distortions in the contribution pattern under the plan.

Qualified cost

In general

The Act provides that the amount of the deduction otherwise allowable to an employer for a year for a contribution to a welfare benefit fund for any taxable year is not to exceed the qualified cost of the fund for the year. The Act defines the qualified cost of a welfare benefit fund for a year as the sum of (1) the qualified direct cost of the fund for the year and (2) the addition (within limits) to the qualified asset account under the fund for the year, reduced by (3) the after-tax income of the fund. A carryover is provided for contributions in excess of the deduction limit. Of course, if a contribution is not allowable as a deduction because, for example, it is considered to be a dividend, then no deduction is allowed in the year of the contribution and no carryover is allowed under the Act. In computing the qualified cost of a welfare benefit fund, no item is to be taken into account more than once.

In the case of a sale of property by an employer to a welfare benefit fund for less than fair market value, the excess of fair market value over the selling price is treated as an employer contribution to the plan. Of course, this rule does not change the rules disallowing deductions for losses on transactions between related parties.[19]

Qualified direct cost

General rule.—Under the Act, the qualified direct cost for a taxable year is the aggregate amount (including administrative expenses) that would have been allowable as a deduction to the employer with respect to the benefits provided by the fund during the taxable year, if the benefits had been provided directly by the employer, and if the employer had used the cash receipts and disbursements method of accounting. For example, in the case of a self-insured medical reimbursement plan, the qualified direct cost equals the actual benefit payments made to employees for the taxable year, plus the administrative costs of providing such benefits.

With respect to the ownership by the fund of recovery property, the qualified direct cost for a year is the deduction that would have been allowed to the employer under section 168 (or sec. 179) for that property for the year if the employer had owned the recovery property. Thus, in the year of a contribution of recovery property by an employer to a fund under a plan, the contribution would be treated as a sale of the property by the employer in that year (as under prior law) and, if the property is placed in service that year, then the employer would be allowed only the deduction with respect to the first year the property is placed in service under the usual rules for determining deductions for recovery property. The same result would occur if the employer contributed cash that the fund used to acquire recovery property. Of course, the limit on the amount allowed as a deduction to the employer for contributions to the fund for the year would take account only of the portion of the facility used to provide employee benefits.

Other deduction limits and restrictions are also "passed through" under the Act to limit deductions with respect to fund contributions. Thus, if an employer contributes amounts that the fund uses for the purchase of land used for an employee recreational facility, then no deduction is allowed with respect to this contribution under the Act because section 263 would not have allowed a deduction if the employer had purchased the land and had provided the benefit directly. Similarly, other expenses of the fund (such as maintenance expenses) with respect to this facility would be qualified direct costs giving rise to employer deductions only if the requirements of section 274 are satisfied. As a further example, fund expenditures for insurance that would not have been deductible under section 264 if made directly by the employer are not qualified direct costs and, thus, no deductions are available to the employer with respect to such expenditures.

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[19] Sec. 267.

Time benefits are considered to be provided.—Under the Act, a benefit is generally considered to be provided when it would be includible in the gross income of the employee if the benefit were provided directly by the employer. If the benefit is excludible from the gross income of the employee because of a provision of the Code, then the exclusion is disregarded in determining the time the benefit is considered to be provided.

For example, if an employer contributes to a fund to pay premiums or consideration for insurance under a plan, then the qualified direct cost for the year would be determined on the basis of the cost of the insurance for the period for which the coverage is provided, without regard to whether any part of that cost is excludable from the gross income of an employee. On the other hand, to the extent that the liability is self-insured and the value of the coverage is not currently includible in gross income (without regard to any applicable exclusion), the time at which benefits would be included would be based on the time at which the benefits are paid, rather than the time of current insurance coverage, because this is the time when benefits would be included (but for any applicable exclusion) if the self-insured benefits were provided directly by a cash method employer.

Child care.—The Act provides that in determining qualified direct cost with respect to a child care facility, in lieu of depreciation, the adjusted basis of the facility is to be allowable as a deduction ratably over a period of 60 months beginning with the month in which the facility is placed in service. The special 60-month deduction rule applies only to tangible personal property that qualifies (under Treasury regulations) as a child care center primarily for children of employees of the employer. The Act provides that property is not to qualify as a child care facility if it is not of a character subject to depreciation or if it is located outside of the United States.

After-tax income

The Act provides that the after-tax income of a welfare benefit fund for a taxable year is the gross income of the fund for the year, reduced by the sum of (1) the amounts allowed as a deduction that are directly connected with the production of that gross income, and (2) the income tax (if any) imposed on the fund for the taxable year.

In determining the gross income of a fund, contributions and other amounts received from employees (dues, fees, etc.) are to be taken into account as income but employer contributions are not to be taken into account. Accordingly, under the Act, welfare benefits are considered to be provided from employer contributions only after the fund's other sources of revenue have been applied to provide benefits. Of course, amounts contributed by an employer pursuant to a salary reduction arrangement under a cafeteria plan (sec. 125) are not to be taken into account as employee contributions in the determination of after-tax income.

Carryovers

If employer contributions paid to a welfare benefit fund during a taxable year would be deductible for the year except that they exceed the deduction limit imposed by the Act, then the part of the contributions in excess of the limit is treated as if it were paid in the succeeding taxable year. Of course, if the contributions otherwise deductible in the succeeding year (including the amount considered to be paid in that year because of the carryover rule) exceed the limit, then the excess would be treated as if it were paid in the next succeeding year. For example, if a portion of 1986 contributions by an employer would have been deductible except that the portion exceeded the qualified cost for that year, then this portion would be considered to be paid in 1987 and would be allowed as a deduction to the extent that this portion and the actual 1987 contributions do not exceed the 1987 qualified cost. To the extent that the sum of the 1986 contributions considered paid in 1987 and the actual 1987 contributions exceed the 1987 qualified cost, they are considered to be paid in 1988, and so forth.

Addition to qualified asset account

In general

The qualified asset account under a welfare benefit fund consists of assets set aside to provide for the payment of disability benefits, medical benefits,[20] supplemental unemployment compensation benefits (SUB),[21] severance pay benefits, or life insurance (including death) benefits. The Act provides an account limit with respect to the amount in the qualified asset account for any year.

The amount in the qualified asset account is the value of the assets in the account (determined under Treasury regulations). Additions to a qualified asset account in excess of the account limit for a year do not increase qualified cost and, therefore, are not deductible for the year. Under the Act, the account limit for a year may not exceed specified safe harbor levels unless the computation of the account limit is certified by a qualified actuary. The Act also provides transition rules for the treatment of excess assets held by a welfare benefit fund.

The Act provides for special account limits (under Treasury regulations) in the case of a qualified asset account under a welfare benefit fund maintained pursuant to a collective bargaining agreement.

Account limit

In general.—The Act provides that the account limit for a qualified asset account for a taxable year is generally the amount reasonably and actuarially necessary to fund claims incurred but unpaid (as of the close of the taxable year) for benefits with respect to which the account is maintained and the administrative costs incurred with respect to those claims; a special limit is provided for reserves for SUB and severance pay benefits.

Claims incurred but unpaid include claims incurred but unreported as well as claims reported but unpaid. This limitation on the account limit is designed to reflect the general policy that a de-

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[20] Sec. 419A(f)(2).
[21] Sec. 501(c)(17)(D).

duction is not to be allowed with respect to an item of expense before the expense has been incurred. Under the Act, a claim is incurred only when an event has occurred that entitles an employee (or the employee's beneficiary) to the benefit. For example, a claim is incurred under a non-insured medical benefit plan when a covered employee has received a service and, thus, incurred an expense covered by the plan. A claim would not be incurred at the time a covered employee becomes ill unless a service covered by the plan is provided at that time. Under the provision, insurance premiums, whenever payable, are not to be regarded as claims incurred but unpaid.

Specific additional reserves are allowed for future provision of post-retirement medical and life insurance benefits.

Life insurance.—In the case of a plan providing life insurance benefits, of course, a claim is incurred upon the death of a covered employee. For example, after the death of an employee covered by a life insurance plan, which provides an annuity for the life of the employee's survivor, the account limit may include the estimated present value of the stream of future benefit payments payable to the survivor. The present value of the benefit payments is to be computed on the basis of actuarial assumptions as to investment yield, administrative costs, and mortality that are reasonable in the aggregate.

Disability benefits.—In the case of disability benefits, the regulations are to provide specific guidance as to the time at which claims are incurred. It was intended by the Congress that a disability is any serious physical or mental impairment which causes an inability to perform a substantial portion of the duties of an individual's ordinary employment. The Congress intended, however, that advance funding of claims with respect to an indefinite period of time is to be allowed only in connection with disabilities which are determined to be long-term disabilities. Such disabilities are those which (1) a medical evaluation determines are expected to last for more than 12 months and (2) have persisted for at least 5 months. With respect to such disabilities, current deductions are to be allowed for contributions necessary to fund the expected stream of future benefit payments using actuarial assumptions that are reasonable in the aggregate, including assumptions as to morbidity, mortality, administrative costs, and investment yield. Other disabilities which have persisted for at least 2 weeks are to be considered short-term disabilities. No more than 5 months of benefit payments are to be deemed to have been incurred with respect to short-term disabilities. In the case of a fund under a plan which provides benefits that supplement workers' compensation payments required by law, claims incurred but unpaid under the disability element of the additional benefit may be taken into account in computing the account limit.

The Act provides that in computing the account limit, disability benefits payable to any individual are not to be taken into account to the extent such benefits are payable at an annual rate in excess of the lower of (1) 75 percent of the individual's average annual compensation for the 3 highest years (sec. 415(b)(3)) or (2) the limit on the annual benefit under a qualified defined benefit pension plan in effect for the current year ($90,000 for 1986).

Post-retirement medical or life insurance benefits.—The account limit for any taxable year may include a reserve to provide for certain post-retirement medical benefits and certain post-retirement life insurance benefits. The qualified asset account limits allow amounts reasonably necessary to accumulate reserves under a welfare benefit plan so that funding of post-retirement medical benefits or post-retirement life insurance benefits (including death benefits) with respect to an employee can be completed upon the employee's retirement. These amounts may be accumulated no more rapidly than on a level basis over the working life of an employee with the employer of that employee. Under the Act, funding will be considered level if it is determined under an acceptable funding method so that future post-retirement benefit and administrative costs will be systematically allocated ratably to future pre-retirement years. The Congress intended that Treasury regulations are to provide rules requiring that funding be based on reasonable and consistently applied actuarial cost methods which take into account experience gains and losses, changes in assumptions, and other similar items and that an acceptable funding method is not to require funding more rapid than on a level basis over the remaining working lifetimes of the current participants with the employer (reduced on the basis of reasonable turnover and mortality assumptions).

Each year's computation of contributions with respect to retiree medical benefits is to be made under the assumption that the medical benefits provided to retirees will have the same cost as medical benefits currently provided to retirees. Because the reserve is to be computed on the basis of current medical costs, future inflation is not to be taken into account and it is to be assumed that the level of utilization will not increase in the future. Accordingly, future experience is not to be assumed to be less favorable than past experience.

In the case of a post-retirement life insurance or death benefit, the Act provides that the account limit is not to include a reserve to the extent the reserve takes account of an amount of insurance that exceeds the amount that may be provided tax-free under section 79. For example, under the Act, the account limit generally does not take into account any amount with respect to life insurance coverage in excess of $50,000, except that the $50,000 limit does not apply in the case of certain employees to whom the amendments made to section 79 in section 223(a) of the Act do not apply. Similarly, in the case of a self-insured death benefit, the account limit is not to include a reserve to the extent that a benefit would be includible in gross income if the limit on excludible death benefits were $50,000.[22]

No deduction for advance funding is to be allowed with regard to a plan which provides medical or life insurance benefits exclusively for retirees, because such a plan would be considered a plan of deferred compensation rather than a welfare benefit plan. Of course, if a plan maintained for retirees is merely a continuation of a plan maintained currently or in the past for active employees, then the

[22] Sec. 101(b).

retiree plan would not be considered a plan of deferred compensation because medical benefits would have been provided without the necessity of retirement or other separation from service. For example, if an employer provides post-retirement medical benefits under a plan for employees who separate by reason of a plant shutdown, and the plan merely continues the benefits provided to those employees (or their dependents) before the shutdown, then the plan would not be regarded as a deferred compensation plan even though its coverage is limited to retirees.

Under the Act, no reserve is to be taken into account in computing the account limit with respect to post-retirement medical or post-retirement life insurance benefits under a plan that does not meet the nondiscrimination rules provided by the Act.

SUB or severance pay benefits.—Under the Act, the account limit for SUB and severance pay benefits for a taxable year is 75 percent of qualified direct costs for those benefits (within limits) during a prior period. Such benefits may include medical or other benefits payable to severed or unemployed workers. The Act provides that the percentage is generally applied to the average annual qualified direct costs for SUB or severance pay benefits (including administrative costs) for any 2 of the preceding 7 taxable years.

The Act limits the amount of SUB or severance pay provided with respect to an employee in a prior year that may be taken into account in computing the annual average. In particular, the amount is limited to the portion of SUB or severance pay benefits that does not exceed 150 percent of the limit in effect for that prior year on the annual addition under a qualified defined contribution plan (sec. 415(c)(1)(A), $30,000 for 1986).

In the case of a new plan (or a plan that has not provided SUB or severance pay benefits in the past), if the plan does not provide SUB or severance pay benefits for any key employee (sec. 416(i)(1)) during a start-up period, then the account limit for those benefits is to be an interim amount determined under Treasury regulations. It is anticipated that, under the regulations, if an employer maintains a funded plan providing SUB or severance pay benefits to key employees and a separately funded plan providing such benefits to other employees, and if the arrangement precludes the possibility of providing such benefits to key employees from the fund for other employees, then the interim limit will be available with respect to the fund for other employees.

Actuarial standards.—In general, in addition to requiring that actuarial assumptions are to be reasonable in the aggregate, Treasury regulations may prescribe specific interest rate and mortality assumptions to be used in all actuarial calculations. The prescribed assumptions are to be consistent with requirements provided by the Act for the computation of reserves held by life insurance companies for income tax purposes. The prescribed assumptions are to be considered reasonable in determining whether actuarial assumptions are reasonable in the aggregate. Of course, in determining the reasonableness of actuarial assumptions, relevant experience of the employer before the time a fund is established to provide a particular benefit may be taken into account.

Certain collectively bargained plans.—The Act provides that by July 1, 1985, the Treasury is to publish final regulations establishing special reserve limit principles with respect to funded welfare benefit plans maintained pursuant to an agreement that the Secretary of Labor finds to be a collective bargaining agreement between employee representatives and one or more employers, if there is evidence of good faith bargaining over the benefits provided by the plan between the employee representatives and the employer (or employers).

In establishing these limits, the Treasury is to presume that reserves in such plans are not excessive because of the arm's length negotiations between adversary parties inherent in the collective bargaining process. Because contributions under such plans are often made on the basis of a defined contribution fixed over a multiyear period on the basis of economic assumptions which prove to be incorrect and because such contributions may be the only source of benefits to be provided during layoffs, strikes, lockouts, and economic recession, these special limits are to allow substantial flexibility in determining the application of these provisions with respect to such plans.

Safe harbor limits

In general.—Unless there is an actuarial certification of the account limit for a taxable year, the account limit for the year is not to exceed the sum of the safe harbor limits for the year. Accordingly, an actuarial certification by a qualified actuary (determined under Treasury regulations) justifying the taxpayer's reserve computations is necessary if the amount in the qualified asset account is above a prescribed safe harbor level equal to the sum of the separate safe harbor amounts computed with respect to each benefit. Even if the safe harbor level is not exceeded, however, the deduction for an addition to a qualified asset account is limited to the amount shown by the taxpayer to be reasonable under the applicable standards provided by the Act (e.g., claims incurred but unpaid).

In computing the safe harbor level for any particular benefit based on the cost of the benefit for a previous period, insurance premiums are not to be taken into account because the Congress did not intend that a fund is to be used as a vehicle for obtaining deductions for prepayment of insurance premiums with respect to benefits. In computing safe harbor limits as a percentage of benefits paid in a prior year, relevant experience of the employer (such as experience under an insurance arrangement) before the time a fund is established to provide a particular benefit may be taken into account.

Short-term disability benefits.—For short-term disability benefits, the safe harbor limit for a taxable year is 17.5 percent of the qualified direct cost (including administrative costs) of short-term disability benefits for the immediately preceding year. As under a computation of the account limit that does not use the safe harbor, the amount of short-term disability benefits taken into account with respect to any individual is limited by reference to the lesser of (1) 75 percent of the individual's average compensation for the high 3 years or (2) the limit on the annual benefit under a qualified defined benefit pension plan.

Medical benefits.—For medical benefits, the safe harbor limit for a taxable year is 35 percent of the qualified direct cost (including administrative costs) of providing the benefit for the immediately preceding taxable year.

SUB or severance pay benefits.—The safe harbor limit for SUB or severance pay benefits is the same as the 75-percent rule described above in connection with account limit computations that do not use the safe harbor.

Long-term disability and life insurance benefits.—The safe harbor limit for long-term disability and life insurance (or death) benefits is to be determined under Treasury regulations.

Separate accounts for certain post-retirement benefits

In order to provide an overall limit with respect to pre-retirement deductions for the retirement benefits of employees and to insure that the effect of any prefunding of these benefits is nondiscriminatory, the Act provides for separate accounting with respect to amounts attributable to contributions made to a welfare benefit fund under the provisions for additional reserves for post-retirement benefits.[23] Separate accounting is required only for contributions, under the post-retirement reserve provisions described above, to provide post-retirement medical or post-retirement life insurance benefits to an individual who is, or ever has been, after the effective date of this section, a key employee (sec. 416(i)(1)).[24]

The amount of medical benefits and life insurance benefits provided under the plan after retirement to an employee with respect to whom these requirements are in effect is to be limited to the balance in the employee's separate account. The amount to be charged against a key employee's account when benefits are provided is to be determined under Treasury regulations. The Congress intended that these regulations will provide for the computation of the amount on the basis of a reasonable estimate of the value of the key employee's coverage under a plan. The Act also provides for the coordination of net contributions for post-retirement medical benefits with the overall limits on contributions and benefits under section 415(c) and (e); any such amount allocated to a separate account, i.e., the excess of the contribution on behalf of any employee for the year over the value of the coverage provided to the employee for the year (if the employee was receiving post-retirement coverage) is to be treated as an annual addition to a defined contribution plan.

Transition rules

The account limit for any of the first 4 taxable years to which the rules for welfare benefit funds apply is increased, under the Act, by the applicable percentage of any existing excess reserve. In particular, the Act provides that, for the first year, the limit is to be the sum of (1) the limit determined without regard to the transitional rule, and (2) 80 percent of the existing excess reserve amount. For the second, third, and fourth succeeding years, 60, 40,

[23] A technical correction may be necessary so that the statute reflects this intent.

[24] The Act does not require the segregation of assets within the fund for this purpose.

and 20 percent, respectively, of the excess reserve amount for such years is substituted for 80 percent.

Under the Act, the existing excess reserve for any year is intended to be the excess of (1) the amount of assets set aside to provide disability, medical, SUB, severance pay, or life insurance benefits under a plan and fund to provide such a benefit in existence on July 18, 1984, as of the close of the first taxable year ending after that date, over (2) the account limit determined, for the year the computation is being made, without regard to the transitional rule.[25] Of course, an unfunded obligation of an employer or employee is not to be considered an asset set aside to provide a benefit. Accordingly, the existing excess reserve does not include any value attributable to such an obligation.

Regulations

The Act authorizes the Secretary of the Treasury to prescribe such regulations as may be necessary to carry out the purposes of the new rules. It is anticipated that under these regulations, the timing and amount of deductions with respect to amounts contributed before the effective date of the Act, and not previously deducted, will be allowed as provided by the rules applicable to deduction carryovers under funded welfare benefit plans. Treasury regulations also may provide for the coordination of taxable years and plan years.

It is also anticipated that Treasury regulations will provide appropriate transition rules for the treatment of amounts contributed to a fund to provide post-retirement medical benefits with respect to an employee who was not a key employee when the contributions were made but who subsequently becomes a key employee (e.g., because of a change in the status of the employee or because of the enactment of the Act). It is expected that the regulations will provide for an allocation to the separate account of the employee (for the year in which key employee status is attained) reflecting the employee's allocable share of the fund and that this initial allocation will not be treated as an annual addition to a defined contribution plan under the overall limits on benefits and contributions (sec. 415). It is also expected that the regulations will limit the initial allocation with respect to a key employee to the amount that would be accumulated on the basis of level funding and reasonable actuarial assumptions (for example, reasonable assumptions as to turnover and mortality).

In addition, the Act specifies that Treasury regulations may provide that a plan administrator of any welfare benefit fund which is a part of a plan to which more than one employer contributes is to submit such information to the employers contributing to the fund as may be necessary to enable the employers to comply with the new rules.

[25] A technical correction may be necessary so that the statute reflects this intent.

Effective Dates

In general

The provision generally applies to contributions paid or accrued after December 31, 1985, in taxable years ending after that date. Special effective date rules apply to certain plans maintained under collective bargaining agreements and to facilities.

Collective bargaining agreements

In the case of certain plans maintained pursuant to 1 or more collective bargaining agreements, the new provisions do not apply to years beginning before the date on which the last of the collective bargaining agreements relating to the plan terminates (determined without regard to any extension thereof agreed to after July 1, 1985). This special effective date for a plan maintained under a collective bargaining agreement applies only if the agreement is between employee representatives and 1 or more employers, and the agreement is in effect on July 1, 1985 (or is ratified on or before that date). The Act provides that a plan amendment made pursuant to a collective bargaining agreement relating to the plan, and which amends the plan solely to conform to a requirement added by the welfare benefit fund rules of the Act, is not to be treated as a termination of the agreement. Of course, the provision is not intended to create an inference that such an amendment would otherwise be considered a termination.

Facilities

The Act provides a special effective date with respect to facilities. Under the Act, the new provisions apply to a contribution of a facility to a welfare benefit fund after June 22, 1984. In addition, the new provisions apply to any other contribution after June 22, 1984, to a welfare benefit fund, to be used to acquire or improve a facility. The Act provides that the special effective date does not apply to a contribution of a facility (or to a contribution to be used to acquire a facility) if the facility is placed in service before January 1, 1987, and (1) the facility is acquired or improved by the fund (or contributed to the fund) pursuant to a binding contract in effect on June 22, 1984, and at all times thereafter, or (2) the construction of the facility by or for the fund began before June 22, 1984.

2. Amendments to Tax on Unrelated Business Income (sec. 511 of the Act and secs. 419A and 512 of the Code)[26]

Prior Law

Tax-exempt organizations generally are subject to income taxes on income from an unrelated trade or business. In the case of a club or a voluntary employees' beneficiary association (VEBA) (secs. 501(c)(7) and (c)(9)), income of the organization generally is not subject to the tax on unrelated business income to the the extent that the income is exempt function income consisting of certain member contributions and amounts set aside to provide permissible benefits. Prior law did not specifically limit the amount of income that could be set aside.

Reasons for Change

The Congress believed that there should be reasonable limits on the extent to which a tax-exempt entity, such as a voluntary employees' beneficiary association (VEBA) or supplemental unemployment compensation benefit trust (SUB), or other fund could accumulate income on a tax-favored basis. Also, the Congress believed that no tax-exempt accumulations should be permitted for certain benefits that may be provided under a VEBA or SUB. Accordingly, the Congress believed that it was appropriate to impose reasonable limits on the amounts that may be set aside on a tax-exempt basis, and that reserves should not be allowed except with respect to self-funded life, sickness, accident, severance pay, and supplemental unemployment compensation benefits.

Explanation of Provisions

In general

The Act modifies the rules of prior law, relating to the tax on unrelated business income of a club or a VEBA, and extends the modified rules to SUBs and group legal service organizations (GLSOs). Under the Act, the tax 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. In addition, the Act provides for the inclusion of a similar amount in the gross income of an employer who maintains a welfare benefit fund that is not exempt from income tax. Of course, amounts contributed to a fund by employees or employers are not to be treated as unrelated business income under these pro-

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[26] For legislative background of the provision, see: committee amendment to H. R. 4170, approved by the House Committee on Ways and Means on March 1, 1984, sec. 114; H. Rep. No. 98-432, Part 2 (March 5, 1984), p. 1292; H. Con. Res. 328, 130 Cong. Rec. (June 29, 1984), H7527; and H. Rep. 98-861 (June 23, 1984), pp. 1161-64 (Conference Report).

visions. Similarly, benefit payments are not to be taken into account as deductible expenses.

Limitation on amount set aside

The Act provides a specific annual limit on the amount of income of a tax-exempt VEBA, SUB, or GLSO (described in sec. 501(c)(9), (17), or (20), respectively) that may be considered a permissible set aside. Under the Act, the amount of such an organization's income for a year that may be considered set aside as exempt function income is generally not to increase the total amount that is set aside to an amount in excess of the account limit for the taxable year determined under the deduction limits provided by the Act (sec. 419A(c) and (f)). The limit on the set-aside is intended to apply to more-than-10-employer VEBAs which are exempt from the deduction limitations.[27]

In general, the rules applicable in computing the account limit under the deduction rules, such as the special reserve limits for collectively bargained plans, also are applicable in determining the set-aside allowed for purposes of the unrelated business income tax. However, for purposes of determining the limit on the set aside, the account limit is not to include any amount with respect to reserves to provide post-retirement medical benefits. The limit on the amount set aside as exempt function income does not include a reserve for post-retirement medical benefits because, in view of the advance deductions provided to employers for these benefits, it was determined that the allowance of such a tax-exempt reserve would provide an unnecessary tax incentive with respect to these benefits.

The value of a facility that is owned by a welfare benefit fund, to the extent used to provide employee benefits, is not taken into account in determining whether the value of the assets of the fund exceeds the account limit.

Transition rule for post-retirement benefits.—The new limitation on the amount which may be set aside for purposes of the unrelated business income tax does not apply to income attributable to certain existing reserves for post-retirement medical or life insurance benefits. This exclusion applies only to income attributable to the amount of assets set aside, as of the close of the last plan year ending before July 18, 1984, for purposes of providing such benefits. The transition relief applies to a reserve to provide such benefits only to the extent the reserve does not exceed the amount that could be accumulated under the principles of Rev. Ruls. 69-382, 1969-1 C.B. 28 and 73-599, 1973-2 C.B. 40. Of course, the obligation of an employer or employee to make future contributions is not to be taken into account as an amount set aside by a fund. The Act provides that all payments of post-retirement medical or life insurance benefits during plan years ending or on after July 18, 1984, are to be charged against the reserve. For this purpose, all plans of an employer are to be treated as one plan, except as provided in Treasury regulations.

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[27] A technical correction may be necessary so that the statute reflects this intent

Certain tax-exempt organizations

The new rules for computing unrelated business income do not apply to an organization if substantially all of the contributions to the organization were made by employers who were exempt from income tax throughout the period of 5 taxable years ending with the taxable year in which the contributions are made. It is expected that under Treasury regulations, in the case of an employer that has been in existence for less than 5 taxable years, the test will generally be applied on the basis of the number of years the employer has been in existence.

Deemed unrelated income

In the case of a welfare benefit fund that is not exempt from income tax (e.g., a retired life reserve account held by a life insurance company or a trust that is not exempt from tax under section 501(c)), the deemed unrelated income of the fund is includible in the gross income of the employer who maintains the fund.[28] The deemed unrelated income of such a fund is the amount of unrelated business income it would have if it were an exempt club, VEBA, SUB, or GLSO. In determining deemed unrelated income, at the election of the employer, two or more non-exempt welfare benefit funds of the employer may be treated as a single fund. Also, under the rules related to deemed unrelated income, the aggregation rules applicable to qualified plans are to apply.

Effective Dates

The provision is intended to be effective for taxable years ending after December 31, 1985, except that the special effective date for funds under collective bargaining agreements applicable to the employer deduction provision also applies to this provision. The provision is intended to be treated as a change in tax rates under Code section 15.[29]

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[28] Sec. 419A(g).

[29] A technical correction will be necessary so that the statute reflects the intended effective date of this provision.

3. Excise Taxes With Respect to Funded Welfare Benefit Plans (sec. 511 of the Act and new sec. 4976 of the Code)[30]

Prior Law

No provision.

Reasons for Change

The Congress was concerned that adequate enforcement of the standards relating to welfare benefit funds requires a sanction triggered by the payment of a benefit that violates those standards. For example, an employer may maintain a plan that complies with the nondiscrimination standards of the Code while a trust under the plan is accumulating assets for a post-retirement life insurance benefit. In such a case, the employer benefits from the deductions and tax-exempt status allowed with respect to such a plan and trust. At a later date, when benefits are to be paid by the trust, the plan may be changed so that it no longer complies with the nondiscrimination standards. Under these circumstances, the loss of tax-exempt status or a denial of deductions for future contributions may have no significant impact on the employer Similarly, loss of exempt status or deductions for the future because of a prohibited reversion is not a meaningful sanction in case of a fund that has ceased to exist.

Accordingly, the Act provides for excise tax sanctions on employers whose plans violate particular standards applicable to welfare benefit funds. An advantage of this penalty provision is that the sanctions are measured by reference to the amount involved in the violation rather than by reference to the entire taxable income of the fund.

Explanation of Provision

If a welfare benefit fund provides a disqualified benefit during a taxable year, then an excise tax is imposed for that year on each employer who maintains the fund. The tax is equal to 100 percent of the disqualified benefit.

Under the Act, a disqualified benefit is intended to be (1) any post-retirement medical or life insurance benefit provided by a welfare benefit fund with respect to a key employee other than through a separate account for that employee,[31] (2) any post-retirement medical or life insurance benefit provided to highly compensated employees under a plan of which the welfare benefit fund is

[30] For legislative background of the provision, see: "Deficit Reduction Act of 1984," as reported by the Senate Committee on Finance on March 21, 1984, sec. 96; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 316-25; H. Con. Res. 328, 130 Cong. Rec. (June 29, 1984), H7527; and H. Rep. 98-861 (June 23, 1984), pp. 1160-61 (Conference Report).

[31] Sec. 419A(d).

a part that does not meet nondiscrimination requirements with respect to the benefit, or (3) any portion of the fund that reverts to the benefit of the employer (whether or not all liabilities of the fund have been previously satisfied).[32] For example, if a fund provides for a reversion after satisfaction of all liabilities to participants and their beneficiaries, and if such a payment is made for the benefit of an employer after the close of the year in which the fund is terminated, then the payment is subject to the excise tax. On the other hand, if an amount is paid by a fund to another fund for the purpose of providing welfare benefits to employees of the employer, then the payment is not to be considered a reversion. Of course, in the case of a sale by a VEBA to the employer (or to a person related to the employer) at less than fair market value, the excess of the fair market value over the sales price would be treated as a reversion. The Act does not modify the rule of ERISA or of the Code under which such a transaction may be prohibited.

Effective Date

The provision generally is intended to apply to disqualified benefits provided after December 31, 1985. However, the provision is not intended to apply to post-retirement medical or life insurance benefits attributable to the amount of assets set aside, as of the last plan year ending before July 18, 1984, for purposes of providing such benefits. The limitations on these amounts and the charging of benefits paid after the end of such year against these amounts is to be subject to rules similar to the rules which apply to the analogous provision under the amendments to the unrelated business income tax.[33]

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[32] A technical correction will be necessary so that the statute reflects this intent.

[33] A technical correction will be necessary so that the statute reflects the intended effective date of this provision.

4. Additional Requirements for Tax-Exempt Status of Certain Organizations (sec. 513 of the Act and sec. 505 of the Code)[34]

Prior Law

Voluntary employees' beneficiary associations (VEBAs)

Statutory requirements

The Code describes VEBAs in the following broad terms: "Voluntary employees' beneficiary associations providing for the payment of life, sick, accident, or other benefits to the members of such association or their dependents or designated beneficiaries, if no part of the net earnings of such association inures (other than through such payments) to the benefit of any private shareholder or individual."

The tax-exempt status of a VEBA does not directly affect either (1) the timing or amount of an employer's deduction for contributions to the VEBA or (2) the timing or amount of the inclusion in income of a welfare benefit provided to an employee under a plan. Many VEBAs provide benefits to employees that are excluded from gross income under a specific statutory provision.

Eligibility for membership

Under the regulations, membership in a VEBA must consist of individuals whose eligibility is determined by reference to objective standards that constitute an employment-related common bond. Such a common bond is deemed to exist if eligibility is determined by the following standards: (1) employment by a common employer (or affiliated employers), (2) coverage under one or more collective bargaining agreements, (3) membership in a labor union (or in one or more locals of a national or international labor union), or (4) employment by one of more employers in the same line of business in the same geographic locale. Under these standards, for example, a group of car dealers in the same city or other similarly restricted discrete geographical locale could form a VEBA to provide permissible benefits to their employees.

Membership in a VEBA generally is limited to employees. Under the regulations, the term employee means an individual who has a legal and bona fide relationship of employer and employee (e.g., for employment tax purposes or for purposes of a collective bargaining agreement).

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[34] For legislative background of the provision, see: committee amendment to H.R. 4170, approved by the House Committee on Ways and Means on March 1, 1984, sec. 113; H. Rep. No. 98-432, Part 2 (March 5, 1984), pp. 1285-91; "Deficit Reduction Act of 1984," as reported by the Senate Committee on Finance on March 21, 1984, sec. 95; S. Prt. 98-169, Vol. I (April 2, 1984), pp 316-25; H. Con. Res. 328, 130 Cong. Rec. (June 29, 1984), H7527; and H. Rep. 98-861 (June 23, 1984), pp. 1161-65 (Conference Report).

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The regulations provide that membership in a VEBA must be voluntary, which requires an affirmative action by the employee to become a member. An employer may automatically include employees provided no detriment is incurred (e.g., deductions from pay) as a result of membership. Such a detriment can be incurred, however, if membership is imposed pursuant to a collective bargaining agreement or incident to membership in a labor organization.

Membership in a VEBA may not be limited to one employee.

Association of employees

A VEBA is not considered an association of employees unless the organization is controlled by (1) the membership, (2) independent trustees, or (3) trustees at least some of whom are designated by, or on behalf of, the membership. The regulations provide that a VEBA is treated as being controlled by independent trustees if it is an "employee welfare benefit plan" under the Employee Retirement Income Security Act of 1974 (ERISA). ERISA subjected employee welfare benefit plans to certain reporting and disclosure requirements and minimum fiduciary standards. If these standards are satisfied, the employer (or an officer of the employer) may serve as trustee of the VEBA.

Permissible benefits

In general, a VEBA may provide life,[35] sick, accident,[36] or other benefits in cash or in kind to members or their dependents or beneficiaries.

The regulations specify that "other" benefits means benefits similar to life, sick, or accident benefits. Under the regulations, such benefits must either (1) be intended to safeguard or improve the health of a member or a member's dependents or (2) protect against a contingency that interrupts or impairs a member's earning power. The following benefits are permissible "other" benefits that the regulations permit a VEBA to provide: (1) vacation benefits, (2) vacation facilities, (3) reimbursed vacation expenses, (4) subsidized recreational activities, (5) child care facilities for pre-school and school age dependents, (6) job readjustment allowances, (7) income maintenance payments in the event of economic dislocation, (8) temporary living expense loans and grants at times of disaster (such as fire or flood), (9) supplemental unemployment compensation benefits,[37] (10) severance benefits,[38] (11) personal legal

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[35] A life benefit means a benefit payable, directly or through insurance, by reason of the death of a member or dependent. Although a life benefit may not include any benefit in the nature of a pension or annuity, it may be settled in the form of an annuity rather than a lump sum.

[36] Under the regulations, sick and accident benefits mean amounts furnished in the event of illness or personal injury of a member or dependent, including amounts paid to a member in lieu of income during a period in which a member is unable to work because of sickness or injury (i.e., disability income). Sick benefits also include benefits designed to safeguard or improve the health of members and their dependents and benefits furnished in noncash form, such a benefits in the nature of clinical care services by visiting nurses and transportation furnished for medical care.

[37] See sec. 501(c)(17).

[38] Such benefits must constitute a severance pay plan within the meaning of Department of Labor Regs. section 2510.3-2(b).

services,[39] and (12) any benefit provided in the manner permitted under section 302(c)(5) et seq. of the Labor Management Relations Act of 1947.

Impermissible VEBA benefits under the regulations include the following: (1) commuting expenses, (2) accident or homeowner's insurance benefits for damage to property, (3) malpractice insurance, (4) loans to members (other than distress loans), (5) savings facilities, and (6) any benefit similar to a pension or annuity payable at the time of mandatory or voluntary retirement or any benefit similar to a benefit provided by a profit-sharing or stock bonus plan.[40]

A VEBA benefit is considered to be similar to a pension or retirement benefit if it becomes payable by reason of the passage of time, rather than as the result of an unanticipated event. Severance pay benefits, which can operate in many ways like deferred compensation benefits, had become increasingly popular VEBA benefits. In some cases, severance pay benefits had been designed to provide cost-of-living adjustments and actuarial reductions for severance prior to attainment of a specified age. It had been suggested that such benefits more closely resemble pension benefits than severance pay benefits.

Nondiscrimination requirements

The VEBA rules of the Code provide that no part of the net earnings of the VEBA may inure, other than through the payment of permissible benefits, to the benefit of any private shareholder or individual. In general, the proscription is designed to ensure that tax-exempt status will be retained only if the organization is operating for tax-exempt purposes, rather than for the benefit of private individuals. Under the VEBA regulations, a VEBA violates this prohibition against inurement if it does not meet certain nondiscrimination standards.

Under the regulations, eligibility criteria for VEBA membership may not be established or administered in a manner that limits membership to officers, shareholders, or highly compensated employees. Similarly, benefits provided by a VEBA cannot be limited to officers, shareholders, or highly compensated employees and cannot disproportionately favor these employees. Generally, this test is not failed merely because certain benefits (such as life insurance) are provided as a uniform percentage of compensation. Also, the regulations permit disability benefits to be integrated (i.e., reduced) on account of social security disability benefits or any "similar plan".[41]

Upon termination of a VEBA, no assets may revert to employers who have contributed to the VEBA. Thus, the assets must be used to purchase permissible benefits in a manner that does not result in prohibited discrimination. Under the regulations, the assets can

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[39] See sec. 501(c)(20).

[40] Treas. Reg. sec. 1.501(c)(9)-3(f). The Tax Court specifically upheld the validity of this provision (and sec. 1.501(c)(9)-3(d)) in *Bricklayers Benefit Plans of Delaware Valley, Inc. v. Commissioner*, 81 T.C. 735 (1983).

[41] Integration with social security apparently has been attempted by some plans even though the employee is covered under a pension plan of the employer that is also integrated with social security and the integration formula under the pension plan takes into account employer contributions for social security disability benefits

be distributed on the basis of objective and reasonable standards that do not result in either unequal payments to similarly situated members or disproportionate payments to the officers, shareholders, or highly compensated employees. If the only members remaining upon termination of the VEBA are officers, shareholders, or highly compensated employees, prohibited discrimination may not result if the assets are distributed to these members in the form of permissible benefits.

Supplemental unemployment compensation benefit trusts

Prior to 1960, supplemental unemployment compensation benefits generally were funded by the employer through a VEBA. Employers generally could not advance fund these benefits because of the limitation on investment income then provided by section 501(c)(9). Consequently, for taxable years beginning after 1959, the Congress provided a tax-exemption for a trust designed primarily to provide supplemental unemployment compensation benefits to employees.[42]

A trust forming part of a plan providing for the payment of supplemental unemployment compensation benefits is eligible for tax-exemption if (1) it is impossible, at any time prior to the satisfaction of all liabilities, for any part of the assets of the trust to be used for the purpose of providing other than unemployment compensation benefits, (2) the employees eligible for the benefits satisfy a classification that does not discriminate in favor of employees who are officers, shareholders, supervisors, or highly compensated employees, and (3) the benefits provided do not discriminate in favor of officers, shareholders, supervisors, or highly compensated employees.

Supplemental unemployment compensation benefits means (1) benefits that are paid to an employee because of involuntary separation from employment with the employer (whether or not temporary) resulting directly from a reduction in force, the discontinuance of a plant or operation, or other similar conditions, and (2) sick and accident benefits that are subordinate to the supplemental unemployment benefits.

In determining whether a supplemental unemployment compensation benefits trust is nondiscriminatory, prior law provides that discrimination does not exist merely because the benefits received under the plan bear a uniform relationship to compensation. Similarly, a plan is not discriminatory merely because the benefits under the plan are reduced by a sick, accident, or unemployment benefit received under state or Federal law or merely because eligibility for the benefits is limited to employees who are not eligible for sick, accident, or unemployment benefits under state or Federal law.

Qualified group legal services organization

An organization created or organized exclusively to form part of a group legal services plan (within the meaning of sec. 120) may be entitled to tax-exemption.

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[42] Sec. 501(c)(17).

Reasons for Change

The Congress believed that employee benefits funded through a tax-exempt organization should not be allowed to discriminate in favor of the employees who influence the design of the benefit plan. The Congress was concerned that the rules of prior law prohibiting discrimination were not sufficiently clear to prevent abuse of the tax-exempt status provided for voluntary employees' beneficiary associations.

The Congress was also concerned that the recent proliferation of tax-exempt organizations used to fund employee benefits made it increasingly difficult for the Internal Revenue Service to monitor the compliance of these entities with the applicable exemption requirements. Accordingly, the Congress believed that it was appropriate to require voluntary employees' beneficiary associations and supplemental unemployment compensation benefit trusts to provide notice of a claim to exempt status.

Explanation of Provision

In general

An association that is otherwise exempt from tax as a voluntary employees' beneficiary association (VEBA) or group legal services organization (GLSO) will not be tax-exempt unless it meets new standards provided by the Act. These standards provide more effective rules prohibiting discrimination in favor of highly compensated employees. Under the Act, the rules aggregating employees of related employers for purposes of testing qualified plans apply (with modifications) in testing VEBAs and GLSOs. Under the Act, an employer must generally treat two or more of its plans as a single plan for purposes of applying the nondiscrimination tests if the plans are treated as a single plan under the rules limiting deductions.

Nondiscrimination

Overview.—The Act establishes new nondiscrimination standards for a tax-exempt VEBA or GLSO. Generally, a VEBA or GLSO meets the nondiscrimination standards of the Act only if, under the plan of which it is a part, (1) each class of benefits under the plan is provided under a classification of employees which is set forth in the plan and that is found by the Secretary of the Treasury not to be discriminatory in favor of employees who are highly compensated, and (2) in the case of each class of benefits, such class of benefits provided does not discriminate in favor of highly compensated employees. In testing whether the benefits are available to a nondiscriminatory classification of employees, employees who decline to make required contributions must be considered.

The Act supplements the nondiscrimination rules of prior law for those VEBAs subject to the rules of the Act. The nondiscrimination standards of the Act do not apply to a VEBA maintained pursuant to a collective bargaining agreement. In determining whether the nondiscrimination standards are satisfied, the Congress intended that the Secretary may take into consideration benefits that vary on account of reasonable and significant geographic disparities. As under prior law, the nondiscrimination standards are applicable with respect to the form of a plan (or exempt organization), its operation, and its termination.

Excluded employees.—Under the Act, certain employees who are not covered by a plan may be excluded from consideration in applying the nondiscrimination standards. These employees are employees who have not attained the age of 21, employees who have not completed 3 years of service with the employer, less than 1/2-time employees and certain nonresident aliens. In addition, employees not included in the plan who are included in a unit of employees covered by an agreement between employee representatives and one or more employers which the Treasury finds to be a collective bargaining agreement may be excluded from the nondiscrimination rules if the class of benefits involved was the subject of good faith bargaining between the employee representatives and the employer or employers. Of course, the status of an organization as a tax-exempt labor organization is not determinative as to whether the organization is, in fact, an employee representative or whether there has been good faith bargaining.

Highly compensated employees.—An employee is considered highly compensated if the employee is highly compensated under the rules for medical reimbursement plans (sec. 105(h)), except that an employee is not considered highly compensated on account of the level of compensation unless the employee is among the highest paid 10 percent (rather than 25 percent) of all employees (other than certain excluded employees).

Integration with Social Security.—Under the nondiscrimination standard of the Act for benefits provided by a VEBA or GLSO, a life, disability, severance pay, or supplemental unemployment compensation benefit is not considered to be discriminatory merely because the benefit bears a uniform relationship to the total compensation, or to the basic or regular rate of compensation, of covered employees. Under the Act, such a benefit generally is not to be integrated with social security benefits or with benefits under a qualified plan or a simplified employee pension. However, integration is permitted in the case of a disability benefit provided by a welfare benefit fund to the extent that social security has not been taken into account under a qualified pension, profit-sharing, or stock bonus plan of the employer or under a simplified employee pension.

The Congress did not intend these new rules for integrating disability benefits to go into effect until the Treasury provides guidance as to their application. Until such guidance is published, employers may rely on prior law.

Under the Act, the rules for integration of welfare benefits differ from the rules for integration of benefits or contributions under a qualified plan. The integration rules for disability benefits under a welfare benefit fund do not distinguish between employer- and employee-derived benefits under the plan or social security disability insurance.

For example, a pension plan may provide a retirement benefit that is reduced by up to 83-1/3 percent of the employee's Primary Insurance Amount under social security. This offset represents the part of the employee's social security benefit that the employer is considered to have provided. It includes the value of the employer's Disability Insurance (DI) contributions as well as the value of the employer's Old-Age and Survivor's Insurance (OASI) contribution. The value of the DI benefit is considered to make up 10 percent of the value of employer-derived social security benefits. Thus, if a pension plan is not more than 90 percent integrated, that plan is not considered to be integrated with the DI benefit under social security and the DI benefit could offset disability benefits under a welfare plan. In such a case, disability benefits under a welfare plan could be reduced by up to 100 percent of the the employee's DI benefit (including family benefits and employee-derived benefits) under social security.

On the other hand, if an employer's qualified plan is more than 90 percent integrated, then the full value of the DI benefit under social security could not be used to reduce disability benefits under a welfare benefit fund because such a reduction would result in double integration. For example, if an employer's qualified pension plan is 93 percent integrated (so that 30 percent of the employer-derived DI benefit under social security has been used by the pension plan), then no more than 70 percent of the DI benefit (including family benefits and employee-derived benefits) could be applied to reduce disability benefits under a welfare benefit fund. Of course, if the pension plan were 100 percent integrated, then the disability benefit under the welfare benefit fund could not be integrated with social security to any extent.

Under the Act, a disability benefit under a welfare benefit fund may be integrated with employee-derived DI benefits whether or not the disability benefit under the plan is derived solely from employee contributions. The Act continues prior law permitting integration of disability benefits with worker's compensation. In addition, the Act does not affect the integration of disability benefits for employees who are disabled before the effective date.

Special standards provided in other Code sections.—Under the Act, if a plan provides a benefit of a type for which a special nondiscrimination standard is provided by the Code, then that benefit is not subject to the general nondiscrimination standard of this provision. Such a benefit will be considered to be nondiscriminatory if and only if it meets the special nondiscrimination standard of the applicable provision of the Code. For example, benefits provided under a medical reimbursement plan would meet the nondiscrimination standard applicable to the tax-exempt status of a VEBA if, and only if, they meet the nondiscrimination standard provided for such plans by section 105(h)(3) and (4).

Notice of claim of exempt status

Under the Act, a VEBA or SUB is required to notify the Internal Revenue Service that it is applying for recognition of its exempt status. The Congress believed that such notice is required for efficient administration of the tax law. Organizations that have previously notified the IRS are not required, under the Act, to renotify the IRS.

Under the Act, an organization is not exempt as a VEBA or a SUB unless it has given the notice in the manner required by Treasury regulations. The organization will not be exempt as a

VEBA or a SUB for any period before the notice is given if the notice is given after the time prescribed by the regulations. In the case of an organization that is in existence on July 18, 1984, the time for giving the notice is not to expire before July 17, 1985.

Related employers, etc.

The Act provides that, in determining whether a VEBA meets the nondiscrimination standards of the Act, rules similar to the rules of secs. 414(b), (c), (m), and (n).

Effective Date

The additional requirements generally apply to years beginning after December 31, 1984. Under the Act, for purposes of determining whether a plan meets the additional requirements, there may (at the election of the employer) be excluded from consideration all disability or severance payments payable to individuals whose benefits are in pay status, i.e., for whom claims have been incurred, as of January 1, 1985. The special exclusion for benefits in pay status, however, does not apply to any payment to the extent it is increased by any plan amendment adopted after June 22, 1984.

5. Study of Employee Benefit Plans (sec. 560 of the Act)[43]

Prior Law

No provision.

Reasons for Change

The Congress was aware that the minimum standards of ERISA and of the Code relating to employee participation, vesting, accrual, and funding applicable to pension plans do not apply to welfare benefit plans. The Congress was concerned that, in the absence of minimum standards, the reasonable expectations of employees and their dependents under welfare benefit plans could be unreasonably disappointed. The Congress was also concerned that the imposition of mimimum standards could have undesirable results if the standards are unnecessary or improperly designed. Accordingly the Act provides for a study by the Secretary of the Treasury of the funding of welfare benefit plans and of appropriate minimum standards.

Explanation of Provision

The Act directs the Secretary of the Treasury to study the possible means of providing minimum standards for employee participation, vesting, accrual, and funding under welfare benefit plans for current and retired employees (including separated employees). The study is to include a review of whether the funding of welfare benefits is adequate, inadequate, or excessive. The Secretary is to report to the Congress with respect to the study by February 1, 1985. The Congress expected that the Secretary will provide suggestions for minimum standards where appropriate.

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[43] For legislative background of the provision, see H. Rep. 98-861 (June 23, 1984), p. 1165 (Conference Report).

6. Treatment of Deferred Compensation Arrangements and Deferred Benefits (sec. 512 of the Act and sec. 404(b)of the Code)[44]

Prior Law

A deduction generally is allowed to an employer for a contribution paid under a nonqualified plan of deferred compensation in the taxable year of the employer in which ends the taxable year in which the contribution is includible in the employee's gross income if separate accounts are maintained.[45] These rules also applied to contributions under a method, as well as a plan, of deferring compensation and to independent contractors as well as employees.[46] Under the rules for nonqualified plans, no deduction is allowed for an employer's contribution unless the contribution meets the usual requirements of the tax law for deductibility (for example, the item must be an ordinary and necessary business expense or an expense with respect to property held for the production of income).

Reasons for Change

The Congress was concerned that an employer may promise to provide an employee or independent contractor with a benefit some time in the future and, even though the benefit is not funded, may claim a deduction before the benefit is provided to the employee. Accordingly, the Congress concluded that it is appropriate to provide that if the benefit or other compensation is provided under a plan, method, arrangement, or similar understanding that a benefit will be provided in the future, then the employer's deduction will be treated as provided under a plan deferring the receipt of compensation unless it is covered by the rules applicable to funded welfare plans.

In addition, the Congress was concerned that there is uncertainty about which of the deduction-timing rules of the Code applies with respect to benefits provided to employees and the scope of these rules insofar as they affect compensation for services provided by independent contractors. The Congress wished to emphasize that the special rules governing employer deductions with respect to funded welfare benefit plans, deferred compensation, and other deferred benefits, are provided in lieu of the general deduction-timing rules of the Code relating to compensation and that their applicability should be carefully considered in all cases involving the timing of deductions with respect to compensation for services.

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[44] For legislative background of the provison, see committee amendment to H.R. 4170, approved by the House Committee on Ways and Means on March 1, 1984, sec. 112; H. Rep. No 98-432, Part 2 (March 5, 1984), pp. 1282-84; H. Rep. 98-861 (June 23, 1984), p. 1160 (Conference Report)

[45] Sec. 404(a)(5).

[46] Sec. 404 (b) and (d).

Explanation of Provision

Certain arrangements for the deferral of compensation

The Act clarifies prior law by providing that an arrangement for compensation having the effect of a plan or method deferring the receipt of compensation does not have to be similar to a stock bonus, pension, profit-sharing, or annuity plan to be subject to the deferred compensation deduction-timing rules. Generally, these rules apply to all compensation arrangements, however denominated, which defer receipt of compensation, fees, or similar payments, by the employee or independent contractor, i.e., arrangements under which the service provider receives compensation more than a brief period of time after the end of the service recipient's taxable year in which the services creating the right to such compensation were performed. For example, under the Act, a limited partnership that uses the accrual method of accounting may not accrue deductions for compensation owed to cash-method taxpayers, who perform services for the partnership, until the partnership taxable year in which such compensation is paid. This rule is consistent with prior law, under which amounts of compensation deferred under an employment contract or year-end bonuses declared by a corporate board of directors, but not paid within a brief period of time after the close of the taxable year, are subject to the deduction-timing rules of section 404 to the extent that another Code provision (e.g., sec. 267(a)(2)) does not operate to deny the deduction.

The Congress intended that the Treasury Department will prescribe rules for the application of the exception from application of the deduction-timing rule for accrued compensation paid within a brief time after the close of the taxable year. However, payment of bonuses or other amounts within 2-1/2 months after the close of the taxable year in which significant services required for payment have been performed is not to be considered a deferred compensation plan. In addition, the Congress did not intend that a situation in which the compensation is unconditionally payable in the year the services are performed, but payment is unexpectedly delayed for a brief period of time due to the temporary financial condition of the payor, is to be treated as a deferred compensation arrangement.

Plans providing deferred benefits

The Act provides generally that whether or not the deferral of compensation takes place under a benefit plan, rather than a compensation plan, is immaterial for the purpose of determining whether the deduction-timing rules of section 404 apply to the plan. Under the Act, any plan, method, arrangement providing for deferred benefits for employees, their spouses, or their dependents is to be treated as a plan deferring the receipt of compensation. The test is to be applied by determining whether a benefit would, if considered to be compensation, be considered to be deferred compensation. A benefit that would be considered deferred compensation under this test is a deferred benefit. An example of a plan which is a deferred benefit plan (unless it is a plan, method or arrangement of deferred compensation) is an extended vacation pay plan, i.e., a plan under which employees gradually, over a period of years, earn the right to additional vacation which cannot be taken until the end of the period. Of course, the determination of whether a plan defers the receipt of compensation is to be made without regard to any income tax rules excluding the benefit from gross income.

Benefits provided through a welfare benefit fund are not to be considered to be provided under a plan of deferred benefits. Under the Act, this exception applies to benefits provided through funds that are subject to the rules for welfare benefit funds[47] or would be subject to those rules but for the effective date of the rules. Further, any vacation benefit to which an election applies under section 463 is not to be considered a deferred benefit.

An unfunded deferred benefit plan will be considered to be a plan of deferred compensation for purposes of the rules relating to the timing and amount of employer deductions for contributions. For example, if a plan provided that current employees will be entitled to life insurance protection, after retirement, that is not merely a continuation of benefits received before retirement, then the benefit will be considered to be deferred compensation with respect to current employees under the Act because, as to those employees, it will not be provided until after retirement. On the other hand, if a plan only provides current benefits for employees, the plan would not be considered a deferred compensation plan merely because it is expected that the plan will continue in existence. Of course, the provision does not change the tax treatment of the employee with respect to the benefit.

Effective Date

In general.—This provision generally applies to amounts paid or incurred after the date of enactment in taxable years ending after that date.

Certain extended vacation pay plans.—In the case of an extended vacation pay plan in effect on June 22, 1984, and maintained under a collective bargaining agreement, the provision is not effective until the agreement terminates (without regard to any extension agreed to after June 22, 1984). Thus, before termination of the agreement, amounts paid under such a plan are subject to the law as in existence before the amendments made by the Act.

7. Revenue Effects of Welfare Benefit Plan Provisions

The provisions described in this part (items 1-6, above) and the provision relating to the accrual of vacation pay (Act section 561) are estimated to increase fiscal year budget receipts by $63 million in 1984, $188 million in 1985, $217 million in 1986, $222 million in 1987, $242 million in 1988, and $280 million in 1989.

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[47] Sec. 419.

B. General Pension Provisions

1. Distribution Rules for Qualified Plans (secs. 521 and 522 of the Act, sec. 242 of TEFRA, and secs. 401, 402, 403, and 408 of the Code)[48]

Prior Law

In general

If a pension, profit-sharing or stock bonus plan qualifies under the tax law ("qualified plan"), then (1) a trust under the plan generally is exempt from income tax, (2) employers generally are allowed deductions (within limits) for plan contributions for the year for which the contributions are made, even though participants are not taxed on plan benefits until the benefits are distributed, and (3) benefits distributed as a lump sum distribution may be accorded special long-term capital gain treatment or 10-year income averaging treatment, or may be rolled over, tax-free, to an individual retirement account or annuity (IRA) or to another qualified plan.

Under a tax-sheltered annuity program, amounts paid by an educational institution or by an eligible tax-exempt organization to purchase an annuity contract for an employee are excluded from the employee's income, subject to certain limits (sec. 403(b)). Excludable contributions to custodial accounts investing in stock of a regulated investment company (e.g., a mutual fund) are also permitted. Amounts distributed or made available under tax-sheltered annuity contracts generally are includible in gross income. However, certain total distributions may be rolled over, tax-free, to another such annuity contract or to an IRA.

Distributions prior to age 59½

Prior law imposed an additional 10-percent income tax on certain distributions to participants in top-heavy plans. Amounts received under a qualified plan before a participant attained age 59½, became disabled, or died were subject to this tax to the extent that (1) the amounts were includible in the participant's gross income and (2) were attributable to benefits accruing in years in which the participant was a key employee in a top-heavy plan. The tax was designed to discourage the use of retirement funds for nonretirement purposes.

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[48] For legislative background of the provision, see: H.R. 4170, approved by the House Committee on Ways and Means on October 21, 1983, sec. 491; H. Rep. No. 98-432 (October 21, 1983), pp. 272-74; committee amendment to H.R. 4170, approved by the House Committee on Ways and Means on March 1, 1984, sec. 491; H. Rep. No. 98-432, Part 2 (March 5, 1984), pp. 1575-77; "Deficit Reduction Act of 1984," as reported by the Senate Committee on Finance on March 21, 1984, secs. 87 and 88; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 304-9; H. Rep. 98-861 (June 23, 1984), pp. 1134-40 (Conference Report); and H. Con. Res. 328, 130 Cong. Rec. S. 8948, H. 7529 (June 29, 1984).

Before-death distribution rules

Benefits provided under a qualified plan must be for the primary benefit of an employee, rather than the employee's beneficiaries. Accordingly, benefits provided for a participant's beneficiaries must be incidental.[49] Under this incidental benefit rule, a qualified plan generally is required to provide for a form of distribution under which the present value of the payments projected to be made to the participant, while living, is more than 50 percent of the present value of the total payments projected to be made to the participant and the participant's beneficiaries. The incidental benefit rule is designed to limit the use of qualified plans for nonretirement purposes (e.g., to provide for deferral of income tax or to provide for tax-favored transfers of wealth to others).

Under prior law, a participant's benefits under a qualified plan were to be distributed by a benefit distribution date, which was the last day of the later of the taxable year in which the participant (i) attained age 70½, or (ii) retired. In the case of a key employee participating in a top-heavy plan, distributions must have been made in the taxable year in which the key employee attained age 70½, without regard to whether the key employee had retired. Alternatively, distributions must have begun no later than the applicable benefit distribution date and must have been made over the life of the participant (or lives of the participant and the participant's spouse) or over a period not exceeding the life expectancy of the participant (or the joint life expectancy of the participant and the participant's spouse).

The distribution rules applicable to individual retirement plans (IRAs) are similar to the before-death distribution rules applicable to benefits under qualified plans except that the benefit distribution date for the owner of an IRA is the end of the taxable year in which the owner attains age 70½, without regard to whether the owner has retired.

After-death distribution rules

If a participant died before the participant's entire interest in a qualified plan was distributed, prior law required that amounts payable to a beneficiary (other than the participant's surviving spouse) generally must have been paid to the beneficiary within 5 years after the participant's death. In addition, after the death of the participant's surviving spouse, any amounts payable to a beneficiary of the surviving spouse must have been paid within 5 years after the spouse's death.

The after-death distribution rules for IRAs were similar to the after-death distribution rules applicable to qualified plans. In addition, amounts in an IRA acquired on account of the death of the IRA owner by an individual other than the owner's spouse could not be rolled over to another IRA.

Under a provision of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA)[50], a plan's qualified status is not adversely af-

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[49] See, e.g., Rev. Rul. 72-241, 1972-1 C.B. 108.
[50] Sec. 242(b)(2) of TEFRA

fected merely because it provides for distributions that do not satisfy the distribution rules added by that Act, provided that (1) the method of distribution satisfies the distribution rules in effect prior to TEFRA (including rules relating to incidental benefits), and (2) the distributions are made pursuant to a qualifying employee designation made before January 1, 1984.

Qualifying rollover distributions

If the balance to the credit of an employee is paid to the employee or to the surviving spouse of the employee as a qualifying rollover distribution, all or any portion of the distribution may be rolled over, tax free, within 60 days after the date of the distribution, to another qualified plan or to an IRA. Under prior law, no rollover was permitted for a plan distribution that was not a total distribution. Similar rules applied to distributions from or under a tax-sheltered annuity contract.

Reasons for Change

The restrictions on plan distributions with respect to key employees in top-heavy plans, added by TEFRA, imposed administrative burdens for plan administrators who were required to identify those employees for whom the restrictions applied. The Congress believed that it was appropriate to reduce administrative burdens by limiting the restrictions to a group that is more easily identified. Also, the Congress believed that the restrictions should apply without regard to top-heavy status.

The Congress was concerned that the prior-law distribution rules restricted the period during which qualified plan distributions to beneficiaries other than the surviving spouses of participants were permitted. A participant may desire to provide one or more individuals, other than the participant's spouse, with the right to receive, in a form that is based on the life or lives of the beneficiary or beneficiaries, any portion of retirement benefits that remain at the participant's death.

In addition, the Congress was concerned that an attempt to develop distribution rules that distinguish among nonspouse beneficiaries on the basis of financial dependency, family relationship, or some other characteristic inevitably will preclude some participants from providing benefits to beneficiaries for whom the participant wishes to provide. Also, the Congress was concerned that an attempt to develop such rules would impose additional administrative burdens on qualified plans and could affect the ability of the Internal Revenue Service to implement rules and monitor compliance.

Finally, the Congress believed that the prior-law rules which prevented a tax-free rollover in the case of at least a 50 percent distribution from a qualified plan or tax-sheltered annuity were unduly harsh. The Congress was aware that some individuals inadvertently violated these rollover rules. Thus, the Congress believed that it was appropriate to permit tax-free rollovers to IRAs in the case of certain partial distributions. However, the Congress found it necessary to prevent abuses of the partial distribution rollover rules by denying favorable tax treatment (e.g., 10-year forward income averaging) to subsequent distributions from a qualified plan.

Explanation of Provisions

Distributions prior to age 59½

Under the Act, the additional 10-percent income tax on premature distributions is intended to apply to a distribution only to the extent that the distribution is attributable to contributions made or benefits accruing in years beginning after 1984 in which the participant was a 5-percent owner (as defined in sec. 416(i)).[51]

Before-death distribution rules

In general.—Under the Act, a trust is not a qualified trust unless the plan of which it is a part provides that the entire interest of the employee will be distributed no later than the required beginning date. Alternatively, the requirements of the Act may be satisfied if the entire interest is to be distributed (in accordance with Treasury regulations), beginning no later than the required beginning date, over (1) the life of the employee, (2) the lives of the employee and a designated beneficiary, (3) a period (which may be a term certain) not extending beyond the life expectancy of the employee, or (4) a period (which may be a term certain) not extending beyond the life expectancy of the employee and a designated beneficiary. For purposes of the before-death distribution rules, an employee's entire interest does not include ancillary benefits (such as lump sum death benefits) that are, in no event, available to the employee.

Designated beneficiary.—Under the Act, a designated beneficiary is an individual designated as a beneficiary by the employee.

Required beginning date.—Under the Act, the required beginning date is generally April 1 of the calendar year following the calendar year in which (1) the employee attains age 70½ or (2) the employee retires, whichever is later. If an employee is a 5-percent owner (sec. 416(i)) with respect to the plan year ending in the calendar year in which the employee attains age 70½, then the required beginning date is generally April 1 of the calendar year following the calendar year in which the employee attains age 70½ even though the employee has not retired. The Act does not, however, require the distribution of employer securities subject to an 84-month holding period (sec. 409(d)) to a 5-percent owner before the expiration of the 84-month period.

Distributions to a participant in a qualified plan who is subject to the age 70½ distribution requirement on the effective date of the Act will not be treated as failing to meet the distribution requirement merely because the plan would have been required to begin payments if the rules had been effective in earlier years. Distributions with respect to such a participant are required to commence on April 1 of the year following the first year for which the provision is effective, based on the individual's age in that year. Thus, the first required beginning date is April 1, 1986.

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[51] A technical correction may be appropriate to reflect the intent that the provision apply only to post-1984 accumulations.

Also, a participant who becomes a 5-percent owner in a year after the year in which the participant attains age 70½ will have a required beginning date of April 1 of the calendar year following the calendar year in which the participant becomes a 5-percent owner.

Minimum distribution requirement.—Under the Act, the Congress intended that Treasury regulations are to require that distributions over any of the permissible periods are to satisfy a minimum distribution requirement similar to the rules under prior law. The minimum amount required to be distributed may be recalculated in the case of benefits payable for life expectancy. The recalculation may be made no more frequently than annually, on the basis of the attained age. For example, recalculation is permitted in the case of benefits payable for the joint lives of an employee and of the employee's spouse, and for the life expectancy of the survivor. The Act does not, however permit recalculation on the basis of the life expectancy of a nonspouse beneficiary. The Congress intended that the method of recalculation in the case of a benefit payable for the joint lives of an employee and a nonspouse beneficiary is to be determined under Treasury regulations which will not permit changes in the life expectancy of the nonspouse beneficiary to be taken into account.

Whether or not the minimum distribution rule has been satisfied is tested separately with respect to each plan in which an employee participates.

Rate of payment.—Distributions from or under a defined benefit pension plan are deemed to meet the minimum distribution requirement if the plan makes substantially nonincreasing annual payments over any of the permissible periods. Under the Act, a series of payments will not fail to be substantially nonincreasing annual payments merely because the payments increase because of (1) certain cost-of-living adjustments, (2) cash refunds of employee contributions upon an employee's death, (3) a benefit increase provided to retired employees, or (4) an adjustment due to the death of the employee's beneficiary. In no event, however, are increasing payments permitted under the Act if the effect of the increase is circumvention of the minimum distribution requirements.

Payment by intermediary.—The minimum distribution requirement of the Act may be satisfied by the distribution of an annuity contract if annuity payments under the contract commence no later than the payments would be required to commence if made directly (an immediate annuity contract) and the payments would meet the minimum distribution requirement if they were made directly by the plan. Similarly, the minimum distribution requirement may be satisfied by a distribution to a trust if the trust precludes the distribution of benefits other than in accordance with the minimum distribution requirements.

Defined contribution plans.—In the case of a defined contribution plan, the minimum distribution requirement is met if the payments under the plan with respect to an employee are subject to an irrevocable payout schedule that meets the minimum distribution rule. Under the Act, the minimum distribution rule does not prevent an employee from changing the beneficiary after benefit distributions have begun if the change does not result in further deferral of benefits.

Relationship to other rules.—The minimum distribution requirement applies in addition to other distribution rules applicable to qualified plans. For example, under the Code, a participant may elect to defer the commencement of benefits (sec. 401(a)(14)), but the deferral elected by the participant is limited by the minimum distribution requirement.

In addition, the Act does not change the incidental benefit rule. For example, if a plan provides for a before-death distribution of an immediate annuity contract to an employee, then the present value of the payments projected to be made under the contract to the employee is to be more than 50 percent of the present value of all benefits to be paid under the contract after taking into account the effect of projected recalculations of life expectancy. The Congress expected that Treasury regulations will not treat a benefit payment as prohibited by the minimum distribution requirements to the extent it is required to be deferred under the rules relating to joint and survivor annuities (sec. 401(a)(11)).

IRAs.—The before-death distribution rules provided by the Act for IRAs are similar to the before-death distribution rules provided for qualified plans and are applied separately to each IRA owned by an individual. For example, distributions from an IRA are required to commence no later than April 1 of the year following the year in which the owner of the IRA attains age 70½. Under the Act, the minimum distribution requirement and the incidental benefit rule apply to IRAs.

After-death distribution rules

The Act provides rules that apply in the case of an employee's death before the employee's entire interest has been distributed. In the case in which distributions have commenced to the employee before death, the Act provides that the remaining portion of the employee's interest is to be distributed at least as rapidly as under the method of distribution in effect prior to death. For example, if an employee elected to receive benefits in the form of equal annual installments for a term of 20 years (which did not extend beyond the life expectancy of the employee) and the employee dies after benefits have been paid for 10 years, the remaining interest of the employee can be distributed in equal annual installments over a term not exceeding 10 years. Of course, the beneficiary could elect to accelerate payments of the remaining interest.

Benefits are not treated as having commenced under the Act until the required beginning date, even though distributions may have actually begun before that date. For example, if a 5-percent owner retires at age 65 and the plan distributes an immediate annuity contract, the benefits are not treated as having commenced until the year in which the 5-percent owner attains age 70-1/2. Thus, if the 5-percent owner dies before attaining age 70-1/2, the after-death distribution rules for distributions that have not commenced are applied.

If distributions have not commenced to the employee before the employee's death, the Act provides that the entire interest of the employee is to be distributed within 5 years after the death of the employee. Under the Act, two exceptions apply to this 5-year distribution rule.

The first exception provides that the 5-year rule does not apply if (1) any portion of the employee's interest is payable to (or for the benefit of) a designated beneficiary, (2) the portion of the employee's interest to which the designated beneficiary is entitled will be distributed over the life of the beneficiary (or over a period (including a term certain) not extending beyond the life expectancy of the beneficiary), and (3) the distributions commence no later than 1 year after the date of the employee's death. The first exception applies only if amounts are paid to the beneficiary under rules that satisfy the minimum distribution rule applicable to before-death distributions. Thus, payments by an intermediary (e.g., a trust) are permissible as long as the intermediary requires payments to be made to the designated beneficiary in accordance with the minimum distribution requirement. Recalculation of life expectancy is not permitted under this provision.

The Secretary may, by regulations, provide exceptions to the 1-year rule under appropriate circumstances (e.g., if a beneficiary cannot be located). Regulations could require that catch-up distributions be made with respect to amounts deferred under such exceptions.

The second exception to the 5-year rule applies if the designated beneficiary is the surviving spouse of the employee. Under this provision, the 5-year rule does not apply if (1) the portion of the employee's interest to which the surviving spouse is entitled will be distributed over the life of the surviving spouse (or over a period not extending beyond the life expectancy of the surviving spouse), and (2) the distributions commence no later than the date on which the employee would have attained age 70½. Recalculation of the surviving spouse's life expectancy is permitted. If the surviving spouse dies before payments commence, then the 5-year rule is applied as if the surviving spouse were the employee. Payments are treated as commencing in the same manner as if the surviving spouse is the employee. Payments to the surviving spouse will satisfy the exception to the 5-year distribution requirement if payments are made pursuant to a qualified joint and survivor annuity.

For purposes of the after-death distribution rules, the Act provides that any amount paid to a child is treated as if it had been paid to the surviving spouse of an employee if the amount becomes payable to the surviving spouse when the child reaches the age of majority (or such other event as may be specified in Treasury regulations).

Under the Act, similar rules are provided for after-death distributions from or under an individual retirement account or annuity. In addition, under the Act, the rules applicable to after-death distributions under an annuity contract are to apply to a custodial account that is treated as a tax-sheltered annuity contract (sec. 403(b)(7)).

Qualifying rollover distributions

Under the Act, distributions of less than the balance to the credit of an employee under a qualified plan or a tax-sheltered annuity contract may be rolled over, tax-free, by the employee (or the surviving spouse of the employee) to an IRA. A rollover of a partial distribution is permitted only if (1) the distribution equals at least 50 percent of the balance to the credit of the employee, determined immediately before the distribution, (2) the distribution is not one of a series of periodic payments, and (3) the employee elects tax-free rollover treatment at the time and in the manner prescribed by the Secretary of the Treasury. For purposes of determining whether a distribution is at least 50 percent of the balance to the credit of the employee under a qualified plan or a tax-sheltered annuity contract, amounts credited under other similar qualified plans or tax-sheltered annuity contracts of the same employer are not counted.

As under prior law, the rollover of a partial distribution is to be made within 60 days after the date of the distribution. If the employee or surviving spouse of the employee elects partial distribution rollover treatment, no portion of the distribution may be rolled over to another qualified plan or a tax-sheltered annuity. In addition, no special treatment is accorded to net unrealized appreciation on employer securities. Any subsequent distribution from the same plan (or any other plan of the employer required to be aggregated for the lump sum distribution rules) is not eligible for the special 10-year forward income averaging and long-term capital gain treatment accorded lump sum distributions. Similarly, if an employee elects partial distribution rollover treatment under a tax-sheltered annuity, a subsequent distribution under any other tax-sheltered annuity of the same employer is not eligible for long-term capital gain treatment.

In the case of a rollover of a partial distribution, the maximum amount rolled over may not exceed the portion of the distribution includible in gross income. Also, amounts in IRAs may not be rolled over to a qualified plan or to a tax-sheltered annuity contract if the balance in the IRA consists, in part, of a rollover of a partial distribution.

For purposes of the 50-percent test, the amount of the balance to the credit of an employee is calculated immediately prior to the distribution.

As under prior law, a partial distribution of deductible employee contributions may be rolled over, tax-free, to an IRA without regard to whether the distribution meets the partial distribution rollover rules added by the Act.

The Act does not require the occurrence of a stated event (such as attainment of age 59½) in order for a partial distribution to qualify for rollover treatment. Thus, for example, the Act does not restrict the availability of a partial distribution rollover by a 5-percent owner. However, the provision does not override the general qualification rules under which certain plans (e.g., pension plans, sec. 401(k) plans) may not make distributions until the occurrence of a specified event.

The Act provides that the surviving spouse of an employee is also eligible for partial distribution rollover treatment. For purposes of testing whether the 50-percent test is met, the balance to the credit of the spouse is computed on the basis of the maximum amount the spouse is entitled to receive under the plan, rather than the total balance to the credit of the employee. For example, if the surviving spouse of an employee is entitled to 50 percent of the balance to the credit of the employee, the surviving spouse could elect to receive and roll over to an IRA 25 percent (one-half of the spouse's interest) of the balance to the credit of the employee. The partial distribution to a surviving spouse can only be rolled over to an IRA, not to a qualified plan.

Effective Dates

The provisions relating to before-death distributions and after-death distributions generally are applicable for years beginning after December 31, 1984.

The Act repeals the provisions relating to before-death and after-death distributions added by TEFRA. However, a plan is not to be disqualified merely because distributions are made in accordance with a designation made before January 1, 1984, by an employee in accordance with section 242(b)(2) of TEFRA. Thus, during 1984, the distribution rules to which qualified plans were subject prior to the enactment of TEFRA are to apply.

With respect to governmental plans, these provisions are effective for years beginning after December 31, 1986.

In the case of a plan maintained pursuant to 1 or more collective bargaining agreements ratified on or before July 18, 1984, between employee representatives and 1 or more employers, the provisions do not apply to years beginning before the earlier of (1) the date on which the last of the collective bargaining agreements relating to the plans (without regard to extensions agreed to after July 18, 1984) expires, or (2) January 1, 1988. A plan amendment pursuant to a collective bargaining agreement made solely to conform to these provisions is not treated as a termination of the collective bargaining agreement. Similarly, if such a plan is amended to remove the restrictions on distributions required by TEFRA, which were repealed in this Act, the plan amendment is not treated as a termination of the collective bargaining agreement.

The provision relating to rollovers of partial distributions is effective for distributions after July 18, 1984.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by less than $5 million annually.

2. Treatment of Distributions of Benefits Substantially All of Which are Derived from Employee Contributions (sec. 523 of the Act and sec. 72 of the Code)[52]

Prior Law

Under a qualified plan, a tax-sheltered annuity, or a government plan, contributions may be made by (1) the employer, (2), the employees, or (3) both. Employee contributions to a qualified plan generally are not deductible by the employee. However, within limits, contributions by an employee that meet certain requirements similar to the rules relating to IRAs may be deductible from gross income. Employee contributions to a qualified plan (whether or not deductible) may not discriminate in favor of employees who are officers, shareholders, or highly compensated. Generally, employee contributions are presumed to be nondiscriminatory if (1) the amount contributed does not exceed certain limits expressed as a percentage of pay, and (2) the opportunity to make the contributions is reasonably available to a nondiscriminatory group of employees.

Nondeductible employee contributions may be withdrawn from a qualified plan at any time without a tax penalty. Under the prior law distribution rules, amounts paid under a qualified plan (including nondeductible employee contributions) were first treated as a return of the nondeductible contributions, which were not includible in gross income. After the balance of the nondeductible contributions had been exhausted, other withdrawals were includible in gross income.

Reasons for Change

The Congress understood that some financial institutions were promoting master and prototype qualified plans that provided for no employer contributions, but instead permitted only employee contributions. The favorable tax treatment of amounts under qualified plans and the ready availability of amounts attributable to nondeductible employee contributions enabled these plans to be used as tax-favored savings and brokerage accounts that could offer employees the opportunity to withdraw funds using credit cards or checks without any amount being included in the employee's income. The Congress believed that the tax treatment of nondeductible employee contributions should be altered in the case of plans in which substantially all of the contributions are employee

[52] For legislative background of the provision, see: Committee amendment to H.R. 4170, approved by the House Committee on Ways and Means on March 1, 1984, sec. 119; H. Rep. No. 98-432, Part 2, March 5, 1984, pp. 1299-1300; "Deficit Reduction Act of 1984," as reported by the Senate Committee on Finance on March 21, 1984, sec. 89; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 310-11; H. Rep. 98-861 (June 23, 1984), pp. 1140-41 (Conference Report).

contributions to ensure that the plans are used as bona fide retirement plans.

Explanation of Provision

Under the Act, if substantially all of the accrued benefits under a qualified plan are derived from employee contributions, then distributions under the plan will be considered to be income until all income has been withdrawn. In addition, if an employee received (directly or indirectly) any amount as a loan under the plan, the Act treats the amount of the loan as a withdrawal from the plan. The Act does not impose any penalty tax on distributions of nondeductible employee contributions.

The Act defines a plan in which substantially all of the contributions are employee contributions as a plan with respect to which more than 85 percent of the total contributions during a representative period (such as 5 years) as determined under Treasury regulations are employee contributions whether or not mandatory). Of course, if less than 85 percent of the total contributions for all years during which the plan is in existence are employee contributions, then the plan is not a plan to which this provision applies.

In addition, under the Act, in the case of the Federal Government or an instrumentality of the Federal Government, the Act provides that the 85-percent test is to be applied by aggregating all plans maintained by the Federal Government or such instrumentality. This aggregation rule applies only to those plans that are actively administered by the Federal Government or the instrumentality. For example, if a plan of the Federal Government was administered by a commercial financial institution, it would not be aggregated for purposes of applying the 85 percent test.

Under the Act, amounts which are contributed to a plan under a qualified cash or deferred arrangement, pursuant to an employee's election to defer, are not treated as employee contributions to the extent that the amounts are not currently includible in gross income (sec. 402(a)(8)). Similarly, deductible employee contributions within the meaning of section 72(o) are not treated as employee contributions for purposes of this provision.

In the case of a pre-existing thrift or savings feature of an employer-funded defined benefit arrangement, the 85-percent test is applied by aggregating the thrift or savings feature with the defined benefit arrangement. This aggregation rule applies only if the employer has consistently treated the 2 features as a single plan, as by consistently filing for (and receiving) one determination letter and filing one annual return covering both features. Employee contributions to a qualified defined benefit pension plan are not treated as a separate defined contribution plan merely because they are taken into account as contributions to a defined contribution plan in applying the overall limits on contributions and benefits (sec. 415).

In addition, if an employer makes contributions to an employer-sponsored defined contribution plan to match employee contributions to a separate union-sponsored defined contribution plan that has also been adopted by the employer, and if such contributions are interrelated by the express terms of the plans so that, for example, withdrawals of employee contributions from the union-sponsored plan will result in forfeitures of employer contributions, the 85-percent test is to be applied by aggregating such employer contributions with employee contributions. If the union-sponsored plan covers employees of more than one employer, then the test is to be applied on an employer-by-employer basis.

Effective Date

The provision applies to any amount received or loan made after October 16, 1984. Loan amounts outstanding on October 16, 1984, which are renegotiated, extended, renewed, or revised after that date generally are treated as loans made on the date of the renegotiation, etc.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $1 million in 1985, $2 million in 1986, $2 million in 1987, $4 million in 1988, and $6 million in 1989.

3. Provisions Relating to Top-heavy Plans (sec. 524 of the Act and sec. 416 of the Code)[53]

Prior Law

In general

Additional qualification standards are provided with respect to a qualified plan that is top-heavy. These additional standards were provided by TEFRA in lieu of provisions of prior law that provided special requirements for plans benefitting a self-employed individual. Accordingly, the TEFRA rules generally apply to a plan without regard to whether it benefits a self-employed individual. The TEFRA rules were designed to provide safeguards for rank-and-file employees and to curb abuse of the special tax incentives available under qualified plans. These rules (1) limit the amount of a participant's compensation that may be taken into account; (2) require accelerated vesting; (3) provide minimum nonintegrated benefits or contributions for plan participants who are not key employees; and (4) reduce the overall limit on contributions and benefits for certain key employees.

Top-heavy status

A qualified plan is top heavy if, as of the determination date, more than 60 percent of the value of benefits accrued under the plan is allocable to key employees. For purposes of determining whether a plan is top heavy for a year, the undistributed accrued benefits of employees who have separated from service generally continue to be counted. Also, in testing whether a plan is top heavy for a year, accrued benefits taken into account generally include benefits distributed during the period of 5 plan years ending on the determination date.

Key employees

An individual is a key employee of an employer if the individual (1) is an officer, (2) is one of the 10 employees owning the largest interests in the employer, (3) owns more than a 5-percent interest in the employer, or (4) owns more than a 1-percent interest in the employer and has compensation from the employer in excess of $150,000. An individual is a key employee with respect to a determination date (and for the plan year for which the determination is made) if the individual was a key employee on any day during the plan year that includes the determination date or any one of the four preceding plan years (including plan years ending before

[53] For legislative background of the provision, see "Deficit Reduction Act of 1984", as reported by the Senate Committee on Finance on March 21, 1984, sec. 86, S. Prt 98-169, Vol. I (April 2, 1984), pp. 301-303; H. Rep. No 98-861 (June 23, 1984) pp. 1132-1134 (Conference Report).

TEFRA's enactment and plan years for which the plan is not top-heavy).

Minimum benefit

A qualified plan that is top-heavy is required to provide a minimum benefit or contribution derived from employer contributions for each employee who is a participant in the plan and who is not a key employee. A defined benefit pension plan satisfies this minimum benefit requirement if, on a cumulative basis, the accrued benefit of each participant who is not a key employee, when expressed as an annual retirement benefit, is not less than two percent of the employee's average annual compensation from the employer during the employee's testing period, multiplied by the number of employee's years of service with the employer. However, an employee's minimum benefit is not required to exceed 20 percent of such average annual compensation. A participant's testing period is the period of consecutive years (not exceeding 5) during which the participant had the highest aggregate compensation from the employer.

For each plan year for which a defined contribution plan is top heavy, each non-key employee is entitled to a minimum employer contribution under the plan. Generally, the minimum employer contribution is 3 percent of the employee's compensation. However, the minimum contribution for a year need not exceed the highest employer contribution rate for any key employee. For example, if, under a profit-sharing plan, no amount is contributed by the employer for any key employee for a year, then no minimum contribution is required for any non-key employee for that year.

Higher levels of minimum benefits are required if employees are entitled to an unreduced overall limit on contributions and benefits.

Under prior law, in testing whether an employer had satisfied the minimum contribution or benefit requirement with respect to a non-key employee and for purposes of determining the amount that had been contributed to a plan on behalf of a key employee, only benefits derived from employer contributions were taken into account. Thus, amounts contributed pursuant to a salary reduction arrangement (including amounts employees had elected to defer under a cash-or-deferred arrangement) were not taken into account as employer contributions.

Reasons for Change

The Congress was aware that special requirements which are unduly complicated or burdensome may tend to discourage employers from continuing or establishing qualified plans. Therefore, the Congress believed that it was appropriate to make certain changes which are consistent with the policy reflected in TEFRA, and which make these rules easier to administer.

In addition, the Congress was aware that many plans established to receive only salary reduction amounts were exempt from the minimum contribution requirements even though such plans were top heavy. Thus, the Congress believed that it was appropriate to take salary reduction amounts into account for purposes of the minimum benefit and contribution rules.

Explanation of Provisions

In general

The Act makes several simplifying changes to the rules for determining whether a plan is top heavy and to the definition of the term key employee. In addition, the Act requires that salary reduction amounts be taken into account for purposes of the minimum benefit rules.

Under the Act, the cumulative accrued benefits of any individual who has not received any compensation from any employer maintaining a plan during the period of 5 plan years ending on the determination date may be disregarded for purposes of determining whether the plan is top-heavy. Solely for purposes of this rule, plan benefits received by the individual are not considered to be compensation. Moreover, if this rule applies to permit an individual's cumulative accrued benefit to be disregarded, plan distributions made during the 5-year period ending on the determination date are disregarded even though they would otherwise be taken into account in determining the accrued benefits under the plan.

Key employees

Under the Act, an employee who is an officer is not considered to be a key employee on account of officer status if the employee's compensation for the year does not exceed 150 percent of the limit on the annual addition under a defined contribution plan[54] (annual additions are limited to $30,000 for 1984 through 1987). For example, for 1985, an employee whose annual compensation from an employer is not more than $45,000 would not be considered to be a key employee on account of officer status in 1985. The determination of whether the employee is a key employee in 1985 on account of officer status in an earlier year is made on the basis of the employee's compensation in the earlier year and the limit on annual additions in effect for the earlier year.

Minimum benefits

The Act provides that amounts contributed to a qualified plan pursuant to a salary reduction arrangement are taken into account in determining top-heavy status. Accordingly, for the purpose of determining the level of minimum contributions to be made and for the purpose of determining whether the minimum contribution has been made, amounts contributed under a salary reduction arrangement (e.g., a qualified cash-or-deferred arrangement) are to be taken into account as employer contributions. Thus, even if no other employer contributions would otherwise be required (e.g. in a salary-reduction only cash-or-deferred plan), an employer who maintained a top-heavy plan to which salary reduction contributions were made by key employees generally would be required to make a minimum contribution on behalf of each non-key employee equal to the lesser of three percent or the highest salary reduction

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[54] Sec. 415.

rate for any key employee. Of course, the required minimum would be reduced by the amount of any salary reduction contributions made by the non-key employee. As under prior law, higher levels of minimum contributions would be required if employees are entitled to an unreduced overall limit on contributions and benefits.

Governmental plans

The Act provides that the additional standards for top-heavy plans do not apply to a governmental plan (as defined in section 414(d)).

Top-heavy plan regulations

Under the Act, if the Secretary of the Treasury fails to issue final regulations under the rules relating to top-heavy plans (as in effect on July 17, 1984), before January 1, 1985, then the Secretary is required to publish model plan amendment provisions that may be incorporated into all qualified plans of an employer. If a plan is amended to incorporate these model amendment provisions, the plan is deemed to have met the top-heavy plan requirements and is not required to be amended further to comply with the top-heavy provisions until the date that is 6 months after the date of the issuance of final regulations. The issuance, as final regulations, of regulations similar to the proposed regulations under section 416 (published on March 15, 1983) will constitute final regulations for purposes of this provision.

If the Secretary fails to publish the required plan amendment provisions by January 1, 1985, a plan is treated as meeting the top-heavy plan requirements if the plan is amended to incorporate the top-heavy provisions by reference. Under the Act, if the rules for top-heavy plans provide for alternatives and a plan incorporates the provisions without specifying the particular alternatives adopted under the plan, the plan is considered to include provisions that maximize the vested, accrued benefits of each non-key employee.

For example, if a plan incorporates the rules relating to vesting under top-heavy plans without specifying the particular vesting schedule it is adopting, then the plan is considered to have elected the vesting schedule for each employee that maximizes that employee's vested benefits. Accordingly, if a non-key employee separates from service after 2 years of service under such a plan, then with respect to that particular employee the plan is considered to have adopted the vesting schedule providing 20 percent vesting for each year of service beginning with the second year of service. If another employee separated from the service of the same employer under that plan after completing 3 years of service, then that employee's employer-derived accrued benefit under the plan would be 100 percent nonforfeitable because, with respect to that employee, the plan would be considered to have adopted the 3-year, 100-percent vesting schedule.

Under the Act, if an employer maintains 2 or more plans and the plans incorporated the rules for top-heavy plans without specifying which of them is to provide the minimum benefit or minimum contribution with respect to non-key employees, then each defined benefit plan is considered to provide for the minimum benefit and each defined contribution plan is considered to provide for the minimum contribution. As a result, if an employee participates in a profit-sharing plan and in a money purchase pension plan of the employer, the employee would be entitled to the minimum contribution under each plan even though the sum of the minimum contributions exceeds 3 percent of the employee's compensation for the year. Similarly, if an employee participates in a both a defined benefit pension plan and a defined contribution plan of the employer, then the employee would be entitled to the minimum benefit under the defined benefit plan in addition to the minimum contribution under the defined contribution plan.

Effective Dates

Generally, the provisions are effective for plan years beginning after December 31, 1983. However, the provisions relating to separated employees and salary reduction arrangements are effective for plan years beginning after December 31, 1984.

Revenue Effect

The provision is estimated to decrease fiscal year budget receipts by less than $10 million annually

4. Repeal of Estate Tax Exclusion for Qualified Plan Benefits (sec. 525 of the Act and sec. 2039 of the Code)[55]

Prior Law

Effective for decedents dying after December 31, 1982, TEFRA reduced the special estate tax exclusion for certain retirement benefits payable under qualified plans, tax-sheltered annuities, individual retirement arrangements (IRAs), and certain military retirement plans to $100,000. This reduced estate tax exclusion for retirement benefits was allowed in addition to any other exclusion or deduction (e.g., the marital deduction (sec. 2056)) allowed with respect to such benefits.

Prior law further restricted the availability of this exclusion by providing that no amount included in a lump sum distribution payable under a qualified plan was eligible for the exclusion unless the beneficiary irrevocably elected not to use the capital gain and 10-year income averaging rules otherwise available for lump sum distributions. Similarly, amounts payable from an IRA were eligible for the exclusion only to the extent such amounts were payable as a qualifying annuity (sec. 2039(e)).

Reasons for Change

The Congress recognized that the $100,000 limit on the estate tax exclusion imposed by TEFRA created complex allocation problems for purposes of calculating the amount of retirement benefits that were excludible from the gross estate. In addition, the Congress believed that a separate estate tax exclusion for retirement benefits provided under qualified plans, etc., was unnecessary because these benefits generally are eligible for the unlimited marital deduction and the unified credit against estate tax. Finally, the Congress generally believed that special estate tax exclusions based on the source of the assets were inappropriate. Therefore, the Congress believed it was appropriate to repeal the separate estate tax exclusion for retirement benefits.

Explanation of Provisions

The Act repeals the separate $100,000 limit on the estate tax exclusion for retirement benefits under qualified plans, tax-sheltered annuities, IRAs, and certain military retirement plans. The Act does not change the treatment of these benefits under other estate tax rules (e.g, the unlimited marital deduction). In addition, the Act retains the prior law rule applicable to certain interests cre-

[55] For legislative background of the provision see: "Deficit Reduction Act of 1984", as reported by the Senate Committee on Finance on March 21, 1984, sec. 90; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 312-313; H. Rep. 98-861 (June 23, 1984), pp. 1141-1142 (Conference Report).

ated by community property laws. Thus, if the spouse of an employee on whose behalf contributions or payments are made to a qualified plan or a tax-sheltered annuity predeceases the participant spouse, the decedent spouse's estate does not include any community property interest in the participant spouse's interest in the employer-derived benefits under the qualified plan.

Effective Dates

The provisions generally are effective with respect to decedents dying after December 31, 1984. However, the provisions do not apply to a decedent whose benefit was in pay status on December 31, 1984, and who, prior to July 18, 1984, made an irrevocable election to designate the form of the retirement benefit distribution (including the form of any survivor benefits). No irrevocable beneficiary designation is required.

The effective date of the TEFRA reduction of the estate tax exclusion to $100,000 is similarly amended to continue the pre-TEFRA unlimited exclusion with respect to a decedent whose benefit was in pay status on December 31, 1982, and who, prior to January 1, 1983, had made an irrevocable election to designate the form of such benefits (but not necessarily the beneficiary thereof).

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $50 million in 1986, $50 million in 1987, $50 million in 1988, and $50 million in 1989.

5. Affiliated Service Groups, Employee Leasing Arrangements, and Collective Bargaining Agreements (secs. 526 and 713 of the Act and secs. 414 and 7701 of the Code)[56]

Prior Law

Affiliated service groups

In general, all employees of employers that are members of an affiliated service group are treated as employed by a single employer for purposes of the qualification requirements for pension, profit-sharing, or stock bonus plans. An affiliated service group consists of a service organization (the "first organization") and (1) each other service organization which is related to the first organization and (2) each other organization which is related to either the first organization, or to a service organization which is related to the first organization. In determining whether a group of employers constitutes an affiliated service group, the constructive ownership rules of section 267 apply.

Employee leasing arrangements

For purposes of certain of the tax-law rules for qualified plans and SEPs, an individual (a leased employee) who performs services for another person (the recipient) is treated as the recipient's employee if the services are performed pursuant to an agreement between the recipient and a third person (the leasing organization) who is otherwise treated as the individual's employer.[57] The individual is treated as the recipient's employee only if the individual has performed services for the recipient (or for the recipient and persons related to the recipient) on a substantially full-time basis for a period of at least 12 months, and if the services are of a type historically performed by employees in the recipient's business field. However, under a safe-harbor provision, an individual who otherwise would be treated as a recipient's employee pursuant to these rules is not treated as such an employee if certain requirements are met with respect to contributions provided for the individual under a qualified money purchase pension plan maintained by the leasing organization.[58]

Collective bargaining agreements

Many of the nondiscrimination standards of the Code applicable to qualified plans do not apply to plans or programs maintained pursuant to an agreement which is found to be a collective bargain-

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[56] For legislative background of the provision, see: "Deficit Reduction Act of 1984", as reported by the Senate Committee on Finance on March 21, 1984, sec. 91; S. Prt. 98-169, Vol. I (April 2, 1984, pp. 314-315; H. Rep. 98-861 (June 23, 1984), pp. 1142-1144 (Conference Report).
[57] Sec. 414(n).
[58] Sec. 414(n)(7).

ing agreement if there is evidence that retirement benefits, etc., were the subject of good faith bargaining between the employer and employee representatives. Similar exclusions are provided with respect to certain welfare benefits provided to employees. Prior law provided no clear definition of an employee representative.

Reasons for Change

The Congress believed it was necessary to change the attribution rules applicable to the determination of whether a group of employers constitutes an affiliated service group in order to prevent abusive circumvention of the rules for qualified pension and welfare benefits.

In addition, the Congress was aware that some individuals had interpreted the safe-harbor rule for employee leasing arrangements as overriding traditional common-law employee rules. The Congress believed that an individual does not cease to be a common-law employee merely because a leasing company provides a pension plan that meets the safe harbor requirements.

Finally, the Congress was concerned that, in some circumstances, owners, officers, and executives of an employer were forming collective bargaining units for purposes of qualifying for the special treatment accorded to qualified plans and to certain fringe benefit programs with respect to employees covered by collective bargaining agreements. This treatment was intended to be limited to legitimate collective bargaining agreements and was not intended to provide a means of avoiding obligations to employees through negotiations between an employer's management, sitting as an employer, and itself, sitting as an employee representative.

Explanation of Provisions

Affiliated service groups

Under the Act, in determining whether a group of employees constitutes an affiliated service group, the broader constructive ownership rules of section 318(a), rather than those of section 267, apply.

Employee leasing arrangement

The Act clarifies the prior law definition of a leased employee by providing that an employee of the recipient is not to be treated as a leased employee with respect to the recipient. Thus, the safe-harbor rule (sec. 414(n)(7)) is inapplicable to a leased employee who is otherwise a common law employee of the recipient. Neither the Act nor TEFRA modified the common-law status of employees of a recipient.

Regulatory authority

In addition, the Act provides the Secretary of the Treasury with regulatory authority to develop any rules as may be necessary to prevent the avoidance of any employee benefit requirement to which the employee leasing provisions apply through the use of employee leasing or other arrangements.[59] The Congress did not

[59] Sec. 414(o).

intend to imply that such regulations could only be applied prospectively.

For example, the Congress was aware of situations in which professionals are hired as leased employees of their own professional corporations in order to avoid the nondiscrimination rules applicable to qualified plans. The Congress intended that regulations will prevent the avoidance of the nondiscrimination rules through the use of such employee leasing arrangements.

Congress did not intend any inference that this example is the sole situation in which employee leasing is used to avoid the qualified plan requirements. In addition, the Congress did not intend to imply that legitimate uses of employee leasing are necessarily abuses. For example, the Congress recognized that the historical use by businesses of temporary help company employees on temporary projects generally is not an avoidance situation subject to the Secretary's regulatory authority provided under the Act if the project has an ascertainable termination date and it is not customary under the circumstances to hire permanent employees for such a project.

Collective bargaining agreements

Finally, the Act clarifies prior law by providing that certain organizations are not employee representatives. Under the Act, in determining whether an employer's plan meets the requirements of the Code, an organization is not considered to be an employee representative if more than one-half of its members participating in the plan are employees who are also owners, officers, or executives of the employer. Self-employed individuals who are considered to be employees under the rules for qualified plans also are treated as employees for purposes of this test. Where a plan is maintained pursuant to a collective bargaining agreement with more than one employee representative, each employee representative is tested separately under this rule.

Of course, plans covering members of an organization which, pursuant to this definition is an employee representative, are eligible for the special rules applicable to collectively bargained plans only if they are maintained pursuant to an agreement which is found to be a collective bargaining agreement and only if there is evidence that retirement, etc., benefits were the subject of good faith collective bargaining between the employer and such employee representative.

Effective Dates

The provisions relating to affiliated service groups are effective for taxable years beginning after December 31, 1984. The employee leasing provisions are effective for taxable years beginning after December 31, 1983. The provisions relating to collective bargaining agreements are effective after March 31, 1984.

Revenue Effect

The provisions will have a negligible effect on budget receipts.

6. Discrimination Standards Applicable to Cash or Deferred Arrangements (sec. 527 of the Act and secs. 401(k) and 402 of the Code)[60]

Prior Law

In general

If a tax-qualified profit-sharing or stock bonus plan meets certain requirements (a "qualified cash-or-deferred arrangement"), then an employee is not required to include in income any employer contributions to the plan merely because the employee could have elected to receive the amount contributed in cash.[61]

The amount a highly paid employee can elect to defer, tax-free, under a qualified cash-or-deferred arrangement depends (in part) on the level of elective deferrals by other employees because a limit is determined by reference to deferrals by other employees and applied to deferrals by the group of highly paid employees. An employee is considered highly paid, for this purpose, if the employee is one of the highest paid 1/3 of the employees.

A cash-or-deferred arrangement will meet these special nondiscrimination requirements for a plan year if (1) the actual deferral percentage for the highest paid 1/3 of all participants does not exceed the actual deferral percentage for the other eligible employees by more than one hundred fifty percent (150%), or (2) the actual deferral percentage for the highest paid 1/3 of all participants does not exceed the actual deferral percentage of the other eligible employees by more than three percentage points. (If the three percent test is used, the actual deferral percentage for the highest paid 1/3 cannot exceed the actual deferral percentage of all other eligible employees by more than two hundred fifty percent (250%).) In calculating these deferral percentages, nonelective contributions by the employer that (1) are nonforfeitable when made and (2) satisfy the withdrawal restrictions applicable to elective deferrals may be taken into account.

The special tests applicable to a cash-or-deferred arrangement do not permit employer social security contributions to be taken into account in determining whether a cash-or-deferred arrangement is discriminatory. However, under prior law, proposed Treasury regulations permitted a cash-or-deferred arrangement to satisfy the general nondiscrimination standards applicable to qualified plans, which permit social security contributions to be taken into account

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[60] For legislative background of the provision, see: H.R. 4170, approved by the House Committee on Ways and Means on October 21, 1983, sec. 807; H. Rep. No. 98-432 (October 21, 1983) pp. 408; committee amendment to H.R. 4170, approved by the House Committee on Ways and Means on March 1, 1984, secs. 120 and 804; H. Rep. 98-432, Part 2 (March 5, 1984) pp. 1301-1302, 1720-21; H. Rep. 98-861 (June 23, 1984), pp. 1144-1146 (Conference Report).

[61] Sec. 401(k).

in testing for discrimination in lieu of the special nondiscrimination requirements.

Money purchase pension plans

Through 1979, the tax treatment of a profit-sharing, stock bonus, or money purchase pension plan with a cash-or-deferred arrangement in existence on June 27, 1974, was determined under pre-ERISA law, as in effect before January 1, 1972. The Revenue Act of 1978 provided rules (sec. 401(k)) for all profit-sharing and stock bonus plans with cash-or-deferred arrangements. No new rules were provided by the 1978 Act for pre-ERISA money purchase pension plans with cash-or-deferred arrangements.

Reasons for Change

The Congress was concerned that prior law permitted employees the flexibility either to receive cash or to have amounts deferred as employer contributions under cash-or-deferred arrangements even though the employer contributions under such arrangements satisfied only the general nondiscrimination rules applicable to qualified plans rather than the special nondiscrimination tests contained in section 401(k). The Congress was concerned that, because the general nondiscrimination rules allow employer social security taxes to be counted as employer contributions, the use of these rules could permit too high a difference between the actual deferrals of highly paid and other employees. Thus, the Congress believed that a cash-or-deferred arrangement should not be treated as a qualified cash-or-deferred arrangement under section 401(k) unless it satisfies the special nondiscrimination test.

In addition, the Congress believed that permanent rules should be provided for a pre-ERISA money purchase pension plan with a salary reduction feature as long as these plans are maintained at the pre-ERISA contribution levels.

Explanation of Provision

The Act (1) requires that all elective deferrals made by a participant under all plans of an employer be aggregated for purposes of calculating that participant's actual deferral percentage; (2) requires a qualified cash-or-deferred arrangement to meet the special deferral percentage tests; and (3) permits the inclusion of qualified cash-or-deferred arrangements in certain pre-ERISA money purchase plans.

Thus, under the Act, it is intended that an employee's actual deferral percentage taken into account for purposes of applying the special deferral percentage tests under any plan of the employer be the sum of the elective deferrals for that employee under each plan of the employer which provides a cash-or-deferred arrangement divided by the participant's compensation from the employer.[62] Of course, as under prior law, where an employer otherwise elects to aggregate two or more plans for purposes of the coverage or discrimination rules, compliance with these special deferral tests is tested on an aggregate basis.

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[62] A technical correction may be appropriate necessary so that the statute reflects this intent.

In addition, the Act provides that a cash-or-deferred arrangement is a qualified cash-or-deferred arrangement only if it meets the special tests provided by the Code relating to actual deferral percentages. If a cash-or-deferred arrangement fails to meet the special tests, an elective deferral made under the arrangement is treated as an employee contribution under the plan which, under the usual rules, could be wholly or partly nondeductible.

A plan which includes an otherwise qualified cash-or-deferred arrangement that satisfies the special tests provided by section 401(k)(3) will be treated as satisfying the general nondiscrimination test of section 401(a)(4) with respect to the elective employer contributions. The mere failure of a cash-or-deferred arrangement to meet the special tests, however, does not result in the disqualification of a plan if the plan continues to meet the usual requirements for qualification.

Money purchase pension plans

The Act applies the cash-or-deferred arrangement rules relating to profit-sharing and stock bonus plans to money purchase pension plans with salary reduction arrangements in existence on June 27, 1974. This treatment applies only if employer and employee contributions under the plan do not exceed the limits under the plan's contribution formula as in effect on June 27, 1974.

Effective Date

The provision applies to plan years beginning after December 31, 1984. However, the rules relating to pre-ERISA money purchase pension plans are effective for plan years beginning after July 18, 1984. Thus, the rules for money purchase pension plans which include a cash-or-deferred arrangement in effect prior to ERISA apply for plan years beginning after December 31, 1979, and before July 18, 1984.

Revenue Effect

The provisions will have a negligible effect on budget receipts.

7. Treatment of Certain Medical, Etc., Benefits under Section 415 (sec. 528 of the Act and secs. 401 and 415 of the Code)[63]

Prior Law

A tax-qualified pension or annuity plan may provide for the payment of certain sickness, accident, hospitalization, and medical expenses for retired employees, their spouses, and their dependents provided certain additional qualification requirements are met with respect to the post-retirement medical benefits. First, the medical benefit, when added to any life insurance protection provided under the plan, must be subordinate to the retirement benefits provided by the plan. The medical benefits are considered subordinate to the retirement benefits if, at all times, the aggregate of employer contributions used to provide such medical benefits and any life insurance protection does not exceed 25 percent of the aggregate contributions, other than contributions to fund past service credits. Additional medical benefits and life insurance protection may be provided with employee contributions.

Second, a separate account must be maintained with respect to contributions to fund such benefits. This separate accounting is determined on an aggregate, rather than a per participant basis, and is solely for record keeping purposes. Third, the employer's contributions to a separate account must be reasonable and ascertainable. Fourth, the plan must preclude the application of amounts in the separate account, at any time prior to the satisfaction of all liabilities with respect to post-retirement benefits, to any other benefits. Last, upon the satisfaction of all plan liabilities to provide post-retirement medical benefits, the remaining assets must revert to the employer and cannot be distributed to the retired employees. Similarly, if an individual's right to medical benefits is forfeited, the forfeiture must be applied to reduce the employer's future contributions for post-retirement medical benefits.

If the requirements with respect to post-retirement medical benefits are met, employer contributions to fund these benefits are deductible under the general rules relating to deductions for contributions to qualified plans. The deduction for such contributions is in addition to the deductions provided for contributions for retirement benefits. The amount deductible may not exceed the total cost of providing the medical benefits, determined in accordance with any generally accepted actuarial method that is reasonable in view of the provisions and coverage of the plan, the funding medium, and any other relevant considerations. In addition, the

[63] For legislative background of the provision, see: committee amendment to H.R. 4170, approved by the House Committee on Ways and Means on March 1, 1984, sec. 116; H. Rep. No. 98-432, Part 2 (March 5, 1984), p. 1051; "Deficit Reduction Act of 1984", as reported by the Senate Committee on Finance on March 21, 1984, sec. 97; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 326-327; H. Rep. 98-861 (June 23, 1984), p. 1145 (Conference Report).

amount deductible for any taxable year may not exceed the greater of (1) an amount determined by allocating the remaining unfunded costs as a level amount or a level percentage of compensation over the remaining future service of each employee, or (2) 10 percent of the cost that would be required completely to fund or purchase such medical benefits. Certain contributions in excess of this limit may be carried over and deducted in succeeding taxable years.

Under prior law, post-retirement medical benefits were not covered by the rules providing limits on contributions and benefits that may be provided under qualified plans.

Reasons for Change

The Congress understood that substantial amounts were being contributed to qualified pension plans to provide post-retirement medical benefits to employees with significant ownership interests in their employers. The Congress believed that the favorable tax treatment accorded these contributions may be subject to abuse unless they are taken into account under the limits on contributions and benefits. Accordingly, the Congress believed that employer contributions to qualified pension plans on behalf of significant owners for medical benefits should be subject to these limits.

Explanation of Provision

In general

The Act amends the qualification rules relating to post-retirement medical benefits to require any pension plan that provides such benefits to create and maintain an individual medical benefit account for any participant who is a 5 percent owner and to treat contributions allocated to such accounts as annual additions for purposes of the overall limits on contributions and benefits.

Individual medical benefit account

Under the Act, a qualified pension plan that provides for the payment of post-retirement medical benefits must establish an individual medical benefit account for each 5 percent owner. A participant's individual medical benefit account is a separate account from which post-retirement medical benefits are payable solely with respect to that participant, the participant's spouse, or the participant's dependents. In addition, this account must be the exclusive source for the payment of any post-retirement benefits attributable to plan years beginning after March 31, 1984, for which the participant is a 5 percent owner. Thus, the amount of medical benefits provided under the plan after retirement to an individual with respect to whom these requirements are in effect is to be limited to the balance in the individual's account. The amount to be charged against the account when benefits are provided is to be determined under Treasury Regulations. The Congress intended that these regulations will provide for the computation of the amount on the basis of a reasonable estimate of the value of the individual's coverage under the plan.

Such an account must be established only for a participant who is, or ever has been, after the effective date of this provision, a 5 percent owner for any plan year during which contributions were made on his behalf. As under the top-heavy plan rules,[64] a participant is treated as a 5 percent owner if the employee owns more than 5 percent of the employer's outstanding stock or stock possessing more than five percent of the total combined voting power of all stock of the employer. An individual is also treated as owning stock owned by certain members of the individual's family or, in certain cases, by partnerships, estates, trusts, or corporations in which the individual has an interest.[65]

In the case of an employer that is not a corporation, ownership is determined in accordance with regulations prescribed by the Secretary of the Treasury. The regulations are to be based on principles similar to the principles of section 318.

Overall limits

In applying the overall limits on contributions and benefits, the net contributions allocated to an individual medical benefit account in a defined benefit plan (i.e., the excess of the contributions on behalf of the individual for the year over the value of coverage provided to the individual for the year if the individual was receiving post-retirement coverage) are to be treated as annual additions under a qualified defined contribution plan. Thus, for purposes of the separately applicable defined contribution plan limits (sec. 415(c)), as well as the combined plan limits (sec. 415(e)), such amounts will be treated as annual additions.

Employee contributions used to provide post-retirement medical benefits will also be allocated to this account and, to the extent required by section 415, may also be considered annual additions.

It is anticipated that Treasury regulations will provide appropriate transition rules for the treatment of amounts contributed to a fund to provide post-retirement medical benefits prior to enactment or provided with respect to an employee who was not a 5 percent owner when the contributions were made but who subsequently becomes a 5 percent owner. It is expected that the regulations will provide for an allocation to the separate account of the employee (for the year in which these rules take effect or in which ownership reaches 5 percent) of an amount reflecting the employee's allocable share of the fund and that this initial allocation will not be treated as an annual addition to a defined contribution plan under the overall limits on benefits and contributions (sec. 415). It is also expected that the regulations will limit the initial allocation with respect to a 5 percent owner to the amount that would be accumulated on the basis of level funding and reasonable actuarial assumptions (for example, reasonable assumptions as to turnover and mortality).

Effective Date

The provision applies to years beginning after March 31, 1984.

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[64] Sec. 416(i)(1)(b).
[65] Sec. 318.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by less than $10 million annually.

8. Certain Alimony Treated as Compensation (sec. 529 of the Act and sec. 219 of the Code)[66]

Prior Law

An individual generally is entitled to deduct from gross income the amount contributed to an individual retirement account or annuity (an IRA) (sec. 219). The limit on the deduction for a taxable year generally is the lesser of $2,000 or 100 percent of compensation (earned income in the case of income from self-employment).

Prior law provided, in certain cases, that alimony received by a divorced spouse could be taken into account under the limits on deductions for IRA contributions. If the requirements of the Code were met, then the IRA deduction limit was not less than the lesser of (1) $1,125 or (2) the sum of the individual's compensation and certain alimony includible in the individual's gross income for the year. This deduction limit applied, however, only if (1) an IRA was established for the benefit of the individual at least five years before the beginning of the calendar year in which the decree of divorce or separate maintenance was issued and (2) for at least three of the most recent five taxable years of the former spouse ending before the taxable year in which the decree was issued, the former spouse paying the alimony was allowed a deduction under the spousal IRA rules for contributions for the benefit of the individual.

Reasons for Change

The Congress believed that whether alimony may be treated as compensation for purposes of the IRA limits should not depend upon whether spousal IRA contributions were made on behalf of the divorced spouse in years prior to the divorce.

Explanation of Provision

The Act repeals the special rules for alimony and treats all taxable alimony received by a divorced spouse as compensation for purposes of the IRA deduction limit.

Effective Dates

The provision applies for taxable years beginning after December 31, 1984.

[66] For legislative background of the provision, see: "Deficit Reduction Act of 1984", as approved by the Senate Committee on Finance on March 21, 1984, sec. 100; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 329-30; and H. Rep. No. 98-861 (June 23, 1984), pp. 1184-85 (Conference Report).

Revenue Effect

The provision is estimated to decrease fiscal year budget receipts by less than $5 million annually.

C. Tax Treatment of Fringe Benefits

1. Exclusion for Certain Fringe Benefits (secs. 531(a), 531(c)-(g), and 532 of the Act, and sec. 117 and new secs. 132 and 4977 of the Code)[67]

Prior Law

General rules

The Internal Revenue Code defines gross income for purposes of the Federal income tax as meaning "all income from whatever source derived," and specifies that it includes "compensation for services" (sec. 61). Treasury regulations provide that gross income includes compensation for services paid other than in money (Reg. sec. 1.61-1(a)). Further, the U.S. Supreme Court has stated that Code section 61 "is broad enough to include in taxable income any economic or financial benefit conferred on the employee as compensation, whatever the form or mode by which it is effected."[68]

The social security and unemployment insurance payroll taxes (FICA and FUTA, respectively) and income tax withholding apply to "wages," defined in the Code as all remuneration for employment, including the cash value of all remuneration paid in any medium other than cash (secs. 3121(a), 3306(b), and 3401(a)). The railroad retirement tax (RRTA) applies to any form of money remuneration (sec. 3231(e)). Regulations applicable to these statutory provisions specify that the value of any noncash item is to be determined by the excess of its fair market value over any amount paid by the recipient for the item (see, e.g., Reg. sec. 31.3121(a)-1(e)).

Certain employee benefits, such as health plan benefits, are specifically excluded by statute from gross income and wages. Nontaxable benefits offered under a plan which offers a choice between

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[67] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, Title V; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1590-1610; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 829; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 776-78; and H. Rep. No. 98-861 (June 23, 1984), pp. 1166-73 (Conference Report).

[68] *Comm'r* v. *Smith*, 324 U.S. 177, 181 (1945); see also, *Comm'r* v. *Kowalski*, 434 U.S. 77 (1977). Similarly, the Court has stated: "Congress applied no limitations as to the source of taxable receipts, nor restrictive labels as to their nature. And the Court has given a liberal construction to this broad phraseology in recognition of the intention of Congress to tax all gains except those specifically exempted" (*Comm'r* v. *Glenshaw Glass Co.*, 348 U.S. 426, 429-30 (1955)). The many types of employee benefits that have been held includible in gross income under this sweeping definition include, among others, commuting or other personal use of company aircraft (e.g., *Ireland* v. *U.S.*, 621 F.2d 731 (5th Cir. 1980)); personal use by an employee of an employer-provided automobile (e.g., *Est. of Runnels* v. *Comm'r*, 54 T.C. 762 (1970); *Dole* v. *Comm'r*, 43 T.C. 697, aff'd per curiam, 351 F.2d 3081 (1st Cir. 1965); *Long Chevrolet Co.* v. *Comm'r*, 26 CCH Tax Ct. Mem. 1054 (1967)); personal use of a company yacht (*Nicholls, North, Buse Co.* v. *Comm'r*, 56 T.C. 1225 (1971)); reimbursement of lunches for employees engaged in nonovernight travel (*Central Ill. Public Service Co.* v. *U.S.*, 435 U.S. 21 (1978)); employer payment or reimbursement of expenses for convention trip not primarily for business purposes (e.g., *Patterson* v. *Thomas*, 289 F.2d 108 (5th Cir.), *cert. denied*, 368 U.S. 837 (1961)); reimbursement of new employee's expenses or economic loss on sale of former residence (e.g., *Bradley* v. *U.S.*, 324 F.2d 610 (4th Cir. 1963); and employer-furnished suits worn by employees (Rev. Rul. 80-322, 1980-2 C.B. 36).

taxable and nontaxable benefits (a "cafeteria plan") may be excluded from gross income if certain conditions are met (sec. 125).

Employer-provided housing

Section 119 excludes from an employee's gross income the value of lodging provided by the employer if (1) the lodging is furnished for the convenience of the employer, (2) the lodging is on the business premises of the employer, and (3) the employee is required to accept the lodging as a condition of employment. Several court decisions have held that on-campus housing furnished to faculty or other employees by an educational institution under the circumstances involved in those cases did not satisfy the section 119 requirements, and hence that the fair rental value of the housing (less any amounts paid for the housing by the employee) was includible in the employee's gross income and constituted wages for income tax withholding and employment tax purposes.[69]

Moratorium on issuance of certain income-tax regulations

In 1975, the Treasury Department issued a discussion draft of proposed regulations which contained a number of rules for determining whether various types of nonstatutory fringe benefits constitute taxable compensation.[70] In general, these benefits involve the acquisition by an employee of goods or services that are regularly sold to the public by the employer, or the use by an employee of property or facilities of the employer, on terms more favorable than those available to the public.

Public Law 95-427, enacted in 1978, prohibited the Treasury Department from issuing, prior to 1980, final regulations under section 61 of the Internal Revenue Code relating to the income tax treatment of fringe benefits. That statute further prohibited Treasury from proposing regulations relating to the treatment of fringe benefits under section 61 which would be effective prior to 1980.

Public Law 96-167, enacted in 1979, extended the moratorium on issuance of fringe benefit regulations through May 31, 1981. That extension prohibited the Treasury Department from issuing, prior to June 1, 1981, final regulations under section 61 relating to the income tax treatment of fringe benefits. In addition, no regulations relating to the treatment of fringe benefits under section 61 were to be proposed which would be effective prior to June 1, 1981.

The Economic Recovery Tax Act of 1981 (Public Law 97-34) extended the moratorium on issuance of fringe benefit regulations through December 31, 1983. Under the 1981 Act, the Treasury De-

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[69] *Bob Jones Univ.* v. *U.S.*, 670 F.2d 167 (Ct. Cl. 1982); *Goldsboro Christian Schools, Inc.* v. *U.S.*, 79-1 CCH USTC para. 9266, E.D.N.C. 1978 (value of lodging furnished to faculty constitutes wages subject to income tax, FICA, and FUTA withholding, in light of "long and consistent history of regulations and rulings, expressly and explicitly applying withholding taxes to lodging not furnished for the employer's convenience***"), *aff'g* order entered in *Goldsboro Christian Schools, Inc.* v. *U.S.*, 436 F.Supp. 1314 (E.D.N.C. 1977), *aff'd* per curiam in unpublished opinion (4th Cir. 1981), *aff'd* 103 S. Ct. 2017 (1983); *Winchell* v. *U.S.*, 564 F.Supp. 131 (D. Neb. 1983) (value of campus home taxed to college president); and *Coulbourn H. Tyler*, 44 CCH Tax Ct. Mem. 1221 (1982).

[70] 40 Fed. Reg. 4118 (Sept. 5, 1975). The discussion draft was later withdrawn (41 Fed. Reg. 5634, Dec. 28, 1976). On January 15, 1981, the Treasury Department forwarded to the Committee on Ways and Means a revised discussion draft of proposed regulations on the tax treatment of fringe benefits. This discussion draft was not reviewed by the Secretary of the Treasury and was not published in the Federal Register. The discussion draft was reprinted in various publications, including Bureau of National Affairs, Daily Executive Report (Jan. 16, 1981), at p. J-14

partment was prohibited from issuing, prior to January 1, 1984, final regulations under section 61 relating to the income tax treatment of fringe benefits. In addition, no regulations relating to the treatment of fringe benefits under section 61 were to be proposed which would be effective prior to January 1, 1984. The Treasury Department announced that Treasury and the Internal Revenue Service "will not issue any regulations or rulings altering the tax treatment of nonstatutory fringe benefits prior to January 1, 1985," and that "present administrative practice will not be changed during this period" (Ann. 84-5, 1984-4 I.R.B. 31).

Reasons for Change

In providing statutory rules for exclusion of certain fringe benefits for income and payroll tax purposes, the Congress struck a balance between two competing objectives.

First, the Congress was aware that in many industries, employees may receive, either free or at a discount, goods and services which the employer sells to the general public. In many cases, these practices are long established, and generally have been treated by employers, employees, and the Internal Revenue Service as not giving rise to taxable income.

Although employees receive an economic benefit from the availability of these free or discounted goods or services, employers often have valid business reasons, other than simply providing compensation, for encouraging employees to avail themselves of the products which those employees sell to the public. For example, a retail clothing business will want its salespersons to wear, when they deal with customers, the clothing which it seeks to sell to the public, rather than clothing sold by its competitors. In addition, where an employer has only one line of business, the fact that the selection of goods and services offered in that line of business may be limited in scope makes it appropriate to provide a limited exclusion, when such discounts are generally made available to employees, for the income employees realize from obtaining free or reduced-cost goods or services. By contrast, allowing tax-free discounts for all lines of business of a conglomerate organization, where the employee might have unlimited choices among many products and services which individuals normally consume or use on a regular basis, would be indistinguishable in economic effect from allowing tax-free compensation in the form of cash or gift certificates. Also, the noncompensatory element involved in providing discounts on the particular products or services that the employee sells to the public may be marginal or absent where an employer offers discounts across all lines of business.

The Congress believed, therefore, that many present practices under which employers may provide to a broad group of employees, either free or at a discount, the products and services which the employer sells or provides to the public do not serve merely to replace cash compensation. These reasons support the decision to codify the ability of employers to continue many of these practices without imposition of income or payroll taxes.

The second objective of the new statutory rules is to set forth clear boundaries for the provision of tax-free benefits. Because of the moratorium on the issuance of fringe benefit regulations, the Treasury Department has been precluded from clarifying the tax treatment of many of the forms of noncash compensation commonly in use. As a result, the administrators of the tax law have not had clear guidelines in this area, and hence taxpayers in identical or comparable situations have been treated differently. The inequities, confusion, and administrative difficulties for businesses, employees, and the Internal Revenue Service resulting from this situation have increased substantially in recent years. The Congress believed that it would be unacceptable to allow these conditions—which had existed since 1978—to continue.

In addition, the Congress was concerned that without any well-defined limits on the ability of employers to compensate their employees tax-free by providing noncash benefits having economic value to the employee, new practices will emerge that could shrink the income tax base significantly. This erosion of the income tax base results because the preferential tax treatment of fringe benefits serves as a strong motivation to employers to substitute more and more types of benefits for cash compensation. A similar shrinkage of the base of the social security payroll tax could also pose a threat to the viability of the social security system above and beyond the adverse projections which the Congress addressed in the Social Security Amendments of 1983. In addition, continuation of the dramatic growth in noncash forms of compensation in recent years—at a rate exceeding the growth in cash compensation—could further shift a disproportionate tax burden to those individuals whose compensation is in the form of cash.

Finally, an unrestrained expansion of noncash compensation would increase inequities among employees in different types of businesses, because not all employers can or will provide comparable compensation packages. For example, consumer-goods retail stores can offer their employees discounts on clothing, hardware, etc.; by contrast, a manufacturer of aircraft engines cannot give its workers compensation in the form of tax-free discounts on its products. Similarly, an unlimited exclusion for noncash benefits discriminates among employers. For example, if tax-free discounts were allowed across all lines of business of an employer, a large employer with many types of businesses (e.g., department store, hotel, airline, etc.) would be given a favorable edge by the tax system in competing for employees as compared with a small firm having one line of business (e.g., a specialty clothing store). Also, a failure to put any limits on the untaxed status of fringe benefits would encourage employers to provide further noncash forms of compensation and thus, in effect, restrict the employees' freedom of choice over how to spend or save their compensation.

Accordingly, the Congress determined that specific rules of exclusion should be set forth in the Code, with limitations on the availability, applicability, and scope of these statutory exclusions. These general limitations include a nondiscrimination rule, the line of business limitation, and the limitation on exclusions to benefits provided to the employee and the employee's spouse and dependent children. In addition, specific limitations apply to particular types of benefits.

The nondiscrimination rule is an important common thread among the types of fringe benefits which are excluded under the Act from income and employment taxes. Under the Act, most fringe benefits may be made available tax-free to officers, owners, or highly compensated employees only if the benefits are also provided on substantially equal terms to other employees. The Congress believed that it would be fundamentally unfair to provide tax-free treatment for economic benefits that are furnished only to highly paid executives. Further, where benefits are limited to the highly paid, it is more likely that the benefit is being provided so that those who control the business can receive compensation in a nontaxable form; in that situation, the reasons stated above for allowing tax-free treatment would not be applicable. Also, if highly paid executives could receive free from taxation economic benefits that are denied to lower-paid employees, while the latter are compensated only in fully taxable cash, the Congress was concerned that this situation would exacerbate problems of noncompliance among taxpayers. In this regard, some commentators argued that the prior-law situation—in which the lack of clear rules for the tax treatment of nonstatutory fringe benefits encouraged the nonreporting of many types of compensatory benefits—led to nonreporting of types of cash income which are clearly taxable under present-law rules, such as interest and dividends.

In addition to enacting specific statutory exclusions covering many fringe benefit practices, the tax treatment of which had been uncertain under prior law, the Congress provided amendments in the Act to Code section 61, defining gross income, and to comparable employment tax provisions. These amendments made clear that any fringe benefit that does not qualify for exclusion under a specific Code provision is includible in the recipient's gross income, and in wages for withholding and other employment tax purposes, at the excess of the fair market value of the benefit over any amount paid by the recipient for the benefit.

The Congress recognized that the inclusion of taxable fringe benefits at fair market value raises valuation issues. However, the problem has been ameliorated because the Act exempts from any taxation a significant portion of benefits made available under existing practices. In addition, the Congress has directed the Treasury to issue regulations, to the extent feasible, setting forth appropriate and helpful rules for the valuation of taxable fringe benefits, to assist both employers, employees, and the Internal Revenue Service.

Also, the Congress understood that valuation issues inherently arise whenever compensation is paid in the form of noncash benefits. For example, both under prior law and the Act, the personal use by an employee (including use by members of the employee's family) of an employer-provided car or plane is includible in income, thereby necessitating a determination of the fair market value of the personal use. While it is understood that as a matter of practice, some taxpayers have not been reporting the full fair market value of such benefits, and that the Internal Revenue Service may not have been actively pursuing the matter on audit, the Congress anticipated that with the enactment in the Act of statutory rules delineating exclusions for fringe benefits, the Internal Revenue Service will be more effective in assuring that all sources of income and wages are properly reported on employer and employee tax returns. The Congress believed that this will help achieve a greater fairness in the tax law, by treating alike employees having equivalent economic income.

In summary, the Congress believed that by providing rules which essentially codify many present practices under which employers provide their own products or services tax-free to a broad group of employees whose work involves those products or services, and by ending the uncertainties arising from a moratorium on the Treasury Department's ability to clarify the tax treatment of these benefits, the Act substantially improves the equity and administration of the tax system.

With respect to certain housing provided to employees by educational institutions, the Congress was aware that court cases have upheld the Internal Revenue Service position that the fair market value of housing (including campus housing) provided by an employer at below fair market value to an employee, less any amounts paid by the employee for the housing, is includible in income and wages. At the same time, to allow further time for consideration of arguments by colleges and universities that special tax rules governing treatment of housing furnished to their employees should be provided by statute, the Congress believed that a moratorium should be imposed on the issuance, prior to 1986, of any regulations which would include in income the value of certain qualified campus lodging furnished in 1984 or 1985.

Explanation of Provisions

a. Overview

Under the Act, certain fringe benefits provided by an employer are excluded from the recipient employee's gross income for Federal income tax purposes, and from the wage base (and, if applicable, the benefit base) for purposes of income tax withholding and FICA, FUTA, and RRTA taxes, if specified requirements are satisfied. Any fringe benefit that does not qualify for exclusion under the Act and that is not excluded under another specific statutory provision of the Code is includible in the recipient's gross income under Code sections 61 and 83, and is includible in wages for withholding and other employment tax purposes, at the excess of its fair market value over any amount paid by the recipient for the benefit.

The excluded fringe benefits are those benefits that qualify under one of the following five categories as defined in the Act: (1) a no-additional-cost service, (2) a qualified employee discount, (3) a working condition fringe, (4) a de minimis fringe, and (5) a qualified tuition reduction. Special rules apply with respect to certain parking and subsidized eating facilities provided to employees, on-premises athletic facilities provided by an employer to employees, and demonstration use of cars by full-time auto salespersons. Some of the exclusions under the Act apply to benefits provided to the spouse and dependent children of a current employee, to former employees who separated from service because of retirement or disability (and their spouses and dependent children), and to the widow(er) of a deceased employee (and the dependent children of deceased employees).

In the case of a no-additional-cost service, a qualified employee discount, subsidized eating facilities, or a qualified tuition reduction, the exclusion applies with respect to benefits provided to officers, owners, or highly compensated employees only if the benefit is made available to employees on a basis which does not discriminate in favor of officers, owners, or highly compensated employees.

The provisions of the Act generally take effect on January 1, 1985, except that the tuition reduction exclusion applies with respect to education furnished after June 30, 1985.

b. No-additional-cost service (sec. 531 of the Act and new Code sec. 132)

General rules

Under this category of excludable fringe benefits, the entire fair market value of any no-additional-cost service provided by an employer to an employee for the use of the employee (see "Definition of employee", below), or for use of the employee's spouse or dependent children, is excluded for income and employment tax purposes. The exclusion applies whether the no-additional-cost service is provided directly for no charge or at a reduced price, or whether the benefit is provided through a cash rebate of all or part of any amount paid for the service.

Subject to an elective grandfather rule (described below), the exclusion applies only if the no-additional-cost service provided to the employee is of the type which the employer offers for sale to nonemployee customers in the ordinary course of the line of business of the employer in which the employee is performing services. Also, the exclusion applies to officers, owners, or highly compensated employees only if the no-additional-cost service is available to employees on a nondiscriminatory basis (see description below of the nondiscrimination rules of the Act).

To qualify under this exclusion, the employer must incur no substantial additional cost in providing the service to the employee, as determined without regard to any amounts paid by the employee for the service. For this purpose, the term cost includes any revenue forgone because the service is furnished to the employee rather than to a nonemployee.

Generally, situations in which employers incur no additional cost in providing services to employees are those in which the employees receive, at no substantial additional cost to the employer, the benefit of excess capacity which otherwise would have remained unused because nonemployee customers would not have purchased it.[71] Thus, employers that furnish airline, railroad, or subway seats

[71] For the purpose of determining whether any revenue is forgone, it shall be assumed that the employee would not have purchased the service unless it were available to the employee at the actual price charged to the employee. This is because the opposite assumption could result in the conclusion that revenue is forgone on every employee free or discounted use of the service (on the ground that otherwise the employee would have paid the full nonemployee price for the service) and hence that no service could ever qualify as a no-additional-cost service.

or hotel rooms to employees working in those respective lines of business in such a way that nonemployee customers are not displaced, and telephone companies that provide telephone service to employees within existing capacity, incur no substantial additional cost in providing these services to employees, as this term is used in the Act.[72]

Line of business limitation

General rules

To be excluded under this category, a service must be the same type of service which is sold to the public (i.e., nonemployee customers) in the ordinary course of the line of business of the employer in which the employee is performing services. (Thus, types of services most of the employer's production of which are provided or sold to the employer's employees rather than to the public do not qualify for this exclusion.) The purpose of the line of business limitation is to avoid, to the extent possible, the competitive imbalances and inequities which would result from giving the employees of a conglomerate or other large employer with several lines of business a greater variety of tax-free benefits than could be given to the employees of a small employer with only one line of business. Thus, small businesses will not be disadvantaged in their ability to compete with large businesses that can provide discounts on an array of goods or services, and employees of small business will not be disadvantaged, in comparison to employees of multifaceted businesses, in terms of receiving tax-free economic benefits.

For purposes of this limitation, a single employer is treated as consisting of more than one line of business if, after aggregating businesses under common control (see "definition of employer," below), the products or services the employer sells to nonemployee customers fall into more than one industry group. In providing guidance as to the treatment of an employer as consisting of one, or of more than one, line of business for this purpose, Treasury regulations may take into account the business segments into which corporations divide themselves for financial reporting purposes. Also, Treasury regulations may refer to the Standard Industrial Classifications used for other governmental purposes.

Under this limitation, for example, an employer which provides both airline services and hotel services to the general public is considered to consist of two separate lines of business. As a consequence, the employees of the airline business of the employer may not exclude, as no-additional-cost services, the fair market value of free or discounted hotel rooms provided to them by their employer (or by any other employer under a reciprocal agreement with their employer); likewise, the employees of the hotel business of the employer may not exclude the fair market value of free or discounted

[72] An employer does incur substantial additional cost (and hence the exclusion is not available) if a substantial amount of time is spent by employees in providing a service for other employees, even if that time may be viewed as "idle" time, or even if the work is performed after normal business hours. By contrast, in the no-additional-cost situation, the services provided to the employee (e.g., the in-flight services provided to an airline employee traveling on a standby basis) are merely incidental to services provided to nonemployee customers

airline tickets provided to them by their employer (or by any other employer under a reciprocal agreement with their employer).

If an employee provides services that directly benefit more than one line of business of the employer, then the individual is treated as performing services in all such lines of business. Thus, in the example in the preceding paragraph, the chief executive officer, payroll department employees, and similar "headquarters" employees may exclude the value of no-additional-cost services provided by either the airline or hotel lines of business of the employer where such employees provide services which directly benefit both those lines of business.

Grandfather rule

The Act provides an elective grandfather rule which, in limited circumstances, relaxes the line of business limitation as otherwise applicable for the exclusion for no-additional-cost services. (See description below under "c. Qualified employee discount"—"Line of business limitation".)

Reciprocal arrangements

Under the Act, an exclusion is available to the employees of one employer for no-additional-cost services provided by an unrelated employer (i.e., another employer not under common control) only if the services provided to such employee (of the first employer) are the same type of services as provided to nonemployee customers by both the line of business (of the first employer) in which the employee works and the line of business (of the other employer) in which the services are provided to such employee. In addition, the exclusion is available to such employee only if both employers are parties to a written reciprocal agreement under which each employer's employees who work in such identical line of business may receive the service from the other employer,[73] and only if neither employer incurs any substantial additional cost (including forgone revenue or payments to the other employer) in providing such service or pursuant to such agreement.

The criteria for determining whether two unrelated employers which have entered into such a reciprocal agreement are providing each other with the same type of service are identical to those described above (under "line of business limitation") for determining the composition of the distinct lines of business comprised by a single employer. Thus, for example, the exclusion is available if two unrelated airlines provide free standby flights to each other's airline employees, but is not available to a hotel's employees if they receive free standby flights from an airline line of business (whether the airline is operated by the employees' employer or another employer).

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[73] Because businesses under common control (such as a parent and subsidiary) are considered to be one employer (see "definition of employer," below), employees of one such commonly controlled business are eligible for the exclusion without the formality of a written reciprocal agreement with the other commonly controlled business(es). Of course, the line-of-business limitation still applies in such cases to the same extent as if the commonly controlled businesses (e.g., the parent and subsidiary corporations) were in fact organized as only one entity.

Definition of employee

The Act provides that, for purposes of the exclusions for no-additional-cost services and qualified employee discounts, with respect to a line of business of an employer, the term employee means, in addition to an individual who is currently employed by the employer in that line of business, (1) an individual who was formerly employed by the employer in that line of business and who separated from service with the employer in that line of business by reason of retirement or disability; (2) a widow or widower of an individual who died while employed by the employer in that line of business; and (3) a widow or widower of a former employee of that line of business who had separated from service with the employer in that line of business by reason of retirement or disability. The Act also provides that for purposes of the exclusions for no-additional-cost services and qualified employee discounts, any use by the spouse or by a dependent child of the employee (as so defined) is to be treated as use by the employee.[74] The definition of employee is relevant both for purposes of eligibility for the exclusion under the Act and for purposes of defining nonemployee customers.

Under the Act's definition of employee, the term dependent child means any child (as defined in Code sec. 151(e)(3)) of the employee (including certain widows or widowers), if the child is a dependent (within the meaning of sec. 152) of the employee, or both of whose parents are deceased. A child of divorced, etc. parents to whom section 152(e) applies is treated as a dependent of both parents for purposes of this provision.

As a result of the Act's definition of employee, the exclusion does not apply to benefits provided to any person other than an employee. Thus, the exclusion is not available for benefits provided to an independent contractor by a person purchasing goods or services from the independent contractor.

Examples

As an illustration of the no-additional-cost service category of excludable benefits, assume that a corporation which operates an airline as its only line of business provides all of its employees (and their spouses and dependent children) with free travel, on the same terms to all employees, as stand-by passengers on the employer airline if the space taken on the flight has not been sold to the public shortly before departure time. In such a case, the entire fair market value of the free travel is excluded under the no-additional-cost service rule in the Act. This conclusion follows because the service provided by the employer to its employees who work in the

[74] Thus, for example, the use of free standby airline services by the spouse and dependent children of an airline employee, or the use of qualified discounts on services or merchandise by the spouse and dependent children of a store employee, are excludable to the same extent as if used by the employee. Under the Act, the fair market value of any use of no-additional-cost services or qualified employee discounts by a person other than the employee, the employee's spouse, or the employee's children, by virtue of the person's relationship to the employee or designation by the employee for such use, is includible in the employee's income and wages. For example, if an airline permits the parents of an employee to fly free on a space-available basis, or allows a discount to the employee's parents on purchase of airline tickets or to the employee on purchase of airline tickets for or used by the employee's parents, the fair market value of such free travel or discount benefit is includible by the employee for income and employment tax purposes (whether or not the parents are dependents of the employee under sec. 152).

employer's airline line of business is the same as that sold to the general public (airline flights), the service is provided at no substantial additional cost to the employer (the seat could not have been sold to nonemployees if the employee had not taken the trip),[75] and the eligibility terms satisfy the nondiscrimination rules of the Act since all employees are eligible for the benefit on the same terms.

This exclusion also applies where employees of the airline line of business of an employer receive free space-available flights from the airline line of business of another employer through a written agreement for the reciprocal exchange of such airline services, if the benefit to the employee would have been excluded under this provision of the Act had it been provided in the same manner by the employee's own employer. Thus, for example, the free flights furnished by the other employer must be available to the employees of the first employer on the same nondiscriminatory basis as required for the exclusion when furnished by the first employer (and vice versa), and neither employer may incur any substantial cost (including forgone revenue or any payment from one employer to the other) in providing the airline services to each other's employees or pursuant to the agreement.

Another example of a no-additional-cost service is the providing of utility services to the employees of the utility where there is excess capacity, such as the providing by a telephone company of free or reduced-cost telephone service to its employees.[76] Where the phone lines, switching capacity, and other overhead already exist, the telephone calls which employees may make without charge or at a reduced price impose no substantial additional cost on the employer. Thus, assuming the telephone service is provided to employees on a nondiscriminatory basis, the requirements of this exclusion category are met, and the fair market value of the service is excluded from gross income and wages.

In contrast, the exclusion for no-additional-cost service is not available under the Act, for example, to an employee in the hotel line of business of a corporation for receipt of free stand-by travel on an airline operated by the same corporation, or to an employee in the corporation's airline business for free or discounted use, on a space-available basis, of the corporation's hotel rooms. Similarly, the exclusion is not available to an employee of (e.g.) a consumer goods manufacturer for the fair market value of any personal use (by the employee or members of the employee's family) of a company jet, even if the plane is otherwise traveling to a particular destination on company business. In each of these cases, even assuming that there were no substantial additional cost to the employer in providing the service on a space-available basis, the service is not the same type generally provided to the general public in the spe-

[75] Neither the provision of meals and refreshments to an employee airline passenger, nor any extra fuel consumption attributable to the weight of the employee passenger and the passenger's luggage, is considered a substantial additional cost, inasmuch as such services are merely incidental to the employer's providing of airline flight services.

[76] Local telephone service and long-distance telephone service are to be considered the same line of business. In this connection, the Congress intended that the fair market value of free local telephone service provided to retired employees of the Bell System is excluded under the Act from income and wages of such retired employees; a technical correction may be necessary to effectuate this transitional rule.

cific line of business of the employer in which the employee-recipient works. Accordingly, the requirements of the no-additional-cost exclusion are not satisfied.

c. Qualified employee discount (sec. 531 of the Act and new Code sec. 132)

General rules

Under this category of excludable fringe benefits, the amount of employee discounts allowed by the employer from the selling price of qualified property or services of the employer is excluded, subject to certain limitations, for income and employment tax purposes. If an employee discount is excludable under this provision but the amount of the exclusion is subject to a specified limitation (described below) based on the employer's gross profit percentage in the case of qualified property or on the selling price of a qualified service, then any excess of the employee discount over the limitation amount is includible in the employee's gross income and wages.

The term employee discount is defined in the Act as the amount by which the price at which the good or service is provided to the employee (for the use of the employee) by the employer is less than the price at which such good or service is being offered by the employer to customers who are not employees. The exclusion applies whether the qualified employee discount is provided through a direct reduction in price or through a cash rebate from the employer or a third party. By contrast to the exclusion for no-additional-cost services, the exclusion for qualified employee discounts is not available for any discounts on goods or services provided by an employer other than the employee's own employer, whether or not a reciprocal discount agreement exists between such employers and whether or not the line of business limitation would be satisfied had the discounted goods or services been provided by the employee's own employer.

Line of business limitation

Subject to two grandfather rules (described below), the exclusion applies only with respect to qualified property or services that are offered for sale by the employer to nonemployee customers in the ordinary course of the line of business of the employer in which the employee is performing services. Also, the exclusion applies to officers, owners, or highly compensated employees only if the employee discount is available to employees on a nondiscriminatory basis (see description below of the nondiscrimination rules of the Act).

The exclusion is not available for employee discounts on any personal property (tangible or intangible) of a kind commonly held for investment and is not available for employee discounts on any real property. Thus, for example, the exclusion does not apply to discounts on any employee purchases of securities, commodities, currencies (including dollars), gold bullion, etc. (regardless of whether a particular purchase is made for investment purposes), and does not apply to discounts on any employee purchases of residential real estate, commercial real estate, or interests in mineral-producing property.[77] Under the Act, a commission or similar fee charged by a brokerage house or an underwriter on sales of securities is treated as a service. Accordingly, if an employee is not charged any commission or similar fee on the purchase of such securities from his or her employer, then the entire amount of such commission or fee as would be charged to nonemployee customers is excludable if the taxpayer establishes that under the facts and circumstances involved, such service qualifies either for the no-additional-cost service exclusion or the de minimis fringe exclusion under the Act, or if the no-commission price charged to the employee is treated as the selling price under the rule stated below applicable when a regularly discounted group selling price is, in effect, the price at which a service is offered to the public (see "Amount of exclusion—Selling price", below). If the discount does not qualify for exclusion under the preceding sentence, then the employee may still receive an excludable discount on such commission pursuant to the qualified employee discount exclusion, subject to the 20-percent limitation discussed below for discounts on services under that exclusion. However, any discount allowed on the price of the security itself is not excludable.

For purposes of this provision, an insurance policy is considered a service; thus, an exclusion is allowed for up to 20 percent of the price of the policy. Also, an employer engaged in leasing property is viewed as providing a service; accordingly, the exclusion is limited to 20 percent of the rental price of the leased property. Neither the qualified employee discount exclusion, nor the exclusion for no-additional-cost services, applies to loans given by banks or other financial or lending institutions to their employees at no interest or an interest rate below the fair market value interest rate.

Line of business limitation

General rules

To qualify under this exclusion, the qualified property or services on which the employee discount is available must be property or services which are offered for sale by the employer to nonemployee customers in the ordinary course of the employer's line of business in which the employee works. (Thus, types of goods or services most of the employer's production of which are provided or sold to the employer's employees do not qualify for this exclusion.) The rules for treatment of an employer as consisting of one or more than one line of business are the same as those described above in connection with the exclusion for a no-additional-cost service.[78] For purposes of the discount exclusion, commonly controlled businesses are treated as one employer (see "definition of employer," below).

By way of illustration of the line of business limitation, merchandise held for sale in the retail department store line of business of

[77] This limitation is provided primarily because the Congress did not believe that favorable tax treatment should be provided when noncash compensation is provided in the form of property which typically the employee could sell at close to the same price at which the employer sells the property to its nonemployee customers.

[78] Thus, for example, the exclusion for qualified employee discounts is not available where an employer which operates an airline and a hotel provides discounted air fare to its employees who work in its hotel line of business, or provides discounted hotel room charges to its employees who work in its airline line of business.

an employer is eligible for the discount exclusion if purchased at a discount by an employee of the employer who works in that line of business. (For this purpose, an employee who works in the store's catalog or mail order units is considered as working in the same line of business as the salesperson selling the items on the store floor.) Similarly, an employee who works for a manufacturer assembling appliances is eligible for the discount exclusion if the employee purchases the assembled appliances from the manufacturer-employer at a discount.

On the other hand, if an employee works for a company that consists of more than one line of business, such as a company consisting of a retail department store business, a hotel business, and an electrical component manufacturing business, an employee is eligible for the discount exclusion only for merchandise or services offered for sale to nonemployee customers in the ordinary course of business in the particular line of business in which the employee performs services. This is the case regardless of whether the employer makes the same discounts available to the employees in the other two lines of business. Thus, in this example, employees of the hotel business or of the electrical component manufacturing business are not eligible for the discount exclusion if these employees purchase merchandise at a discount from the employer's department store. However, employees of units of the employer that provide repair or financing services with respect to particular retail merchandise sold by the employer are considered as providing services in that retail merchandise line of business and hence are eligible for excludable discounts on such merchandise items.

Grandfather rules

Two grandfather rules under the Act relax the line of business limitation in certain existing situations.

First rule. — If (1) on and after October 5, 1983, the employees of one member (the "first member") of an affiliated group[79] were entitled to employee discounts at retail department stores operated by another member (the "second member") of the affiliated group, and (2) in the year for which the income and employment tax determination is being made, most of the sales of the affiliated group are attributable to the operation of retail department stores, then, for purposes of the exclusion for qualified employee discounts (sec. 132(a)(2)), the first member of the affiliated group is to be treated as engaged in the same line of business as the second member (the operator of the department stores). Thus, the employees of the first member may exclude otherwise qualified employee discounts received at the retail department stores operated by the second member. This rule does not operate in the reverse direction, however; that is, employees working in the department stores may not exclude any discounts received on property or services offered by the other member of the affiliated group, whether or not such discounts were allowed on October 5, 1983.

Second rule. — The Act provides an additional, elective grandfather rule which in certain circumstances relaxes the line of busi-

[79] For this purpose, affiliated group has the same meaning as under sec. 1504, but determined without regard to secs. 1504 (b)(2) and (b)(4).

ness limitation requirement for the exclusion for qualified employee discounts and (to the extent described below) for the exclusion for no-additional-cost services.

This elective grandfather rule applies if all the following requirements are met:

(1) On and after January 1, 1984, the employer offers discounts on qualified property or services in a particular line of business to substantially all[80] its employees in all of its lines of business which existed on January 1, 1984;

(2) The employee works in a line of business of the employer which was a line of business of the employer on January 1, 1984; and

(3) The employer timely elects the applicability of this grandfather rule.

If all three requirements are met for the elective grandfather rule, all employees of any line of business of the employer which was in existence on January 1, 1984[81] are treated, for purposes of the exclusions for no-additional-cost services and qualified employee discounts, as employees of the particular line of business (which was in existence on January 1, 1984) in which such qualified property or services are offered for sale by the employer. Thus, under the grandfather rule, exclusions for no-additional-cost services or qualified employee discounts (if otherwise available) extend to the providing by an employer of discounts on goods or services in a particular line of business to an employee who works in a line of business of the employer other than that line of business in which such goods or services on which the discount is available are offered for sale by the employer. However, this treatment does not apply for purposes of new Code section 132(g)(2), which otherwise extends the exclusion for no-additional-cost services to services made available under certain reciprocal agreements between employers.

This elective grandfather rule applies on a calendar-year basis. If elected, the rule applies to the first calendar year following the year of election and to all subsequent calendar years unless revoked by the employer. A revocation must be made prior to the beginning of the calendar year to which the grandfather rule is not to apply. The election (and any revocation) must be made in the manner prescribed by Treasury regulations. All employees treated as employed by a single employer under sections 414(b), 414(c), or 414(m) are treated as employed by a single employer for purposes of the elective grandfather rule.

Under the Act, an employer making the election is subject to an excess fringe benefit excise tax for any calendar year for which the grandfather rule election is in effect if the aggregate fair market value of all excludable no-additional-cost services and qualified employee discounts (including benefits excludable only under the

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[80] In determining whether the "substantially all" test is met, the term employee includes retired employees, etc. described in new Code sec. 132(f)(1) only if the employer in fact then offered discounts to such classes of persons. If the employer did not on January 1, 1984, offer discounts except to current employees, then the "substantially all" test is to be applied without regard to the persons described in sec. 132(f)(1). For purposes of the elective grandfather rule, it was intended that the term employees means the employees of the U.S. operations of the employer.

[81] Thus, the elective grandfather rule cannot apply to employees of a line of business entered into by the employer after January 1, 1984.

grandfather rule) provided by the employer during the calendar year to all its employees exceeds one percent of the total of all compensation (includible in gross income) paid by the employer during the year to all its employees. This computation takes into account all employees in all lines of business of the employer, including lines of business as to which the elected grandfather rule does not apply (e.g., where the line of business did not exist on January 1, 1984).

The rate of the excise tax under new Code section 4977 is 30 percent of the excess described in the preceding sentences. The amount of the tax is not deductible by the employer.

Definition of employee

The definition of employee for purposes of the exclusion for qualified employee discounts is the same as for purposes of the exclusion for no-additional-cost services (described above). Thus, for example, the exclusion does not apply to discounts provided to or for the use of any person other than an employee of the employer (or the employee's spouse or dependent children).

Amount of exclusion

General rule.—Under the Act, an employee discount is excluded only up to a specified limit. In the case of qualified property, the excludable amount of the discount is limited to the selling price of the property, multiplied by the employer's gross profit percentage. The discount exclusion for a qualified service may not exceed 20 percent of the selling price, regardless of the actual gross profit percentage.

Merchandise.—In the case of qualified property, the excludable amount of the discount may not exceed the price at which the property is being offered by the employer to customers, multiplied by the employer's gross profit percentage. The employer's gross profit percentage for a period means the excess of the aggregate sales price for the period of qualified property sold by the employer to customers in the relevant line of business over the aggregate cost of such property to the employer, then divided by the aggregate sales price of such property. For purposes only of computing the gross profit percentage, customers includes employee customers.[82]

For example, if total sales of qualified property during a year were $1,000,000 and the employer's cost for the merchandise was $600,000, then the gross profit percentage for the year is 40 percent ($1,000,000 minus $600,000 equals 40 percent of $1,000,000). Thus, a qualified employee discount with respect to such merchandise is excludable from income and wages to the extent it does not exceed 40 percent of the selling price of the merchandise to customers. If in this case the discount allowed to the employee exceeds 40 percent (for example, 50 percent), the excess discount on a purchase (10

[82] Under sec. 132(i) of the Act, the term customers includes employee customers only for purposes of sec. 132(c)(2)(B). It is anticipated that a technical correction will apply the same definition for purposes of sec. 132(c)(2)(A).

percent in the example) is included in the employee's gross income and wages.[83]

For purposes of determining the employer's profit percentage, cost is to be computed by the employer in the same manner as it is for computing the employer's Federal income tax liability, under the inventory rules in Code section 471 and the regulations thereunder. Thus, for example, a retailer is to use the "retail method" of pricing inventories under Treas. Reg. sec. 1.471-8 in computing cost for purposes of the gross profit percentage discount limitation if that is the method used by the employer to value inventories for income tax purposes.

The Act provides that an employer may compute the gross profit percentage on the basis of all merchandise held for sale to customers (including employee customers) in the employer's line of business in which the employee is performing services. As an alternative, the employer may select any reasonable classification of such qualified property for the computation. For example, a retail department store business may compute a gross profit percentage for the store business as a whole, or may compute different gross profit percentages for different departments or types of merchandise (high markup items versus low markup items), provided such classifications are made on a reasonable basis. Under either computation method, the determination of the gross profit percentage is to be made on the basis of the employer's experience during a representative period, such as the prior year.

Services.—In the case of qualified services, the excludable amount of the discount may not exceed 20 percent of the selling price of the service; there is no profit percentage limitation. The selling price is the price at which the service is being offered in the ordinary course of business to nonemployee customers.

Selling price.—Regulations under section 61 for the valuation of nonexcluded discounts provided to employees are to provide that if, in a line of business, a discounted price is, in effect, the price at which a product or service is offered to the public because a discount is regularly provided by the employer in the ordinary course of business through arrangements negotiated with large groups of consumers (e.g., to all members of professional associations) and substantial sales are made at a discount under these agreements, then the fair market value of the discounted products or services is to be measured by reference to the regularly discounted group selling price. In such a case, the regularly discounted group selling price also is to be used to compute the limit on the exclusion for qualified employee discounts on services, for example, so that an employee includes amounts in income on a purchase of services at a discount only to the extent that the price charged to the employee was less than 80 percent of the discounted group selling price.

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[83] This result occurs because the amount included in gross income as gross income attributable to a discount sale, under section 61, is the difference between fair market value and the price the employee pays for the merchandise. Since the fair market value of merchandise when sold to employees is the price at which the merchandise is being offered by the employer to customers who are not employees, the 50-percent discount in the example is included in gross income but for the exclusion to the extent the exclusion applies. Under the Act, a discount of 40 percent is excluded from gross income. The net result is that 10 percent of the selling price is included in the employee's gross income for income tax purposes (and in wages for withholding and employment tax purposes).

Leased sections of department stores

In cases in which a department store leases floor space to another employer (such as a cosmetics firm), and employees of the lessee engage in over-the-counter sales of merchandise which appear to the public to be made by department store employees, then, for purposes of the exclusion in the Act for qualified employee discounts, the leased section is treated as part of the line of business of the employer operating the department store, and the employees of the lessee who are in the leased section are treated as employees of the department store. Thus, even if such individuals selling cosmetics on the department store floor are actually employees of the cosmetic company rather than of the store, they are considered employees of the department store for purposes of the exclusion for qualified employee discounts on store products sold by the employer.

Accordingly, if these individuals in the leased section receive from the store a qualified discount on their purchases of goods in the store other than cosmetics, the amount of the discount (subject to the profit percentage limitation) is excluded from income. (Of course, the exclusion is not available to other employees of the cosmetics firm who do not engage in over-the-counter sales in the leased section of the store.) Likewise, because the cosmetic section itself is considered part of the department store line of business, any qualified discount allowed to department store employees by the cosmetics firm to purchase cosmetics in the leased section is excluded (subject to the profit percentage limitation).

d. Working condition fringe (sec. 531 of the Act and new Code sec. 132)

General rules

Under the Act, the fair market value of any property or services provided to an employee of the employer is excludable for income and employment tax purposes as a working condition fringe only if and to the extent that payment for the property or services by the employee would have been deductible by the employee as an ordinary and necessary business expense (under Code secs. 162 or 167) had the employee, rather than the employer, paid for such property or services. If such deduction would have been allowable only if certain substantiation requirements (e.g., under secs. 274 or 280F) are satisfied, then the exclusion for working condition fringes is available only if such substantiation requirements are satisfied with respect to the property or services provided.

The nondiscrimination rules applicable to certain other excludable fringe benefits under the Act do not apply as a condition for exclusion as a working condition fringe.

Examples

By way of illustration, the fair market value of use by an employee of a company car or corporate jet solely for section 162 business purposes is excludable as a working condition fringe (assuming any applicable substantiation requirements are satisfied). However, the fair market value of the use of a company car or plane by an employee (or members of the employee's family) for personal purposes is includible in the employee's income and wages. Merely incidental personal use of a company car, such as a small detour for a personal errand while on a business trip, might qualify for exclusion as a de minimis fringe, but regular personal use (e.g., after business hours or on weekends) or use on vacation trips cannot qualify for an exclusion.

As another example, assume an employer subscribes to business periodicals for an employee (e.g., a brokerage house buys a financial publication for its brokers) or reimburses the employee for the cost of membership dues in a professional association (e.g., a law firm reimburses its librarian for membership dues in a professional law librarians' association). In these situations, the fair market value of the subscriptions or the amount of membership dues is an excluded working condition fringe, since the expense could have been deducted as a business expense had the employee directly paid the subscription price or the membership dues.

Examples of other benefits excluded as working condition fringes are those provided by an employer primarily for the safety of its employees, if the costs of such safety precautions would be deductible by the employee as ordinary and necessary business expenses. For example, if strictly for security reasons the U.S. Government or a private business provides a bodyguard or car and driver to an employee, the fair market value of the bodyguard or use of the car and driver is treated as a working condition fringe, and hence is not includible in income or wages of the employee, to the extent the cost of such safety precautions would have been deductible under section 162 if paid by the employee. Other examples of excluded working condition fringes are employer expenditures for on-the-job training or travel by an employee if such expenditures, if paid by the employee, would meet the requirements (including any substantiation requirements) for deductibility under section 162.

In contrast, assume that an employer agrees to pay the real estate broker's commission on the sale of an employee's house to assist the employee in moving to another job site for the employer. The payment of the commission by the employer is not excludable as a working condition fringe, because direct payment of the commission expense by the employee would not be deductible by the employee as a section 162 business expense.[84] Similarly, the exclusion for working condition fringes is not available for employer reimbursements of "supper money" or transportation costs of employees working overtime at the office, since such meals and commuting costs are nondeductible personal expenditures (although occasional supper money, taxi fare, or parking expense reimbursements because of overtime work may be excludable as de minimis fringes).

Product testing rule

The fair market value of the use of consumer goods which are manufactured for sale to nonemployee customers and which are provided to employees for product testing and evaluation outside

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[84] Some or all of this amount might be deductible, however, as a moving expense under Code sec. 217.

the employer's premises is excluded as a working condition fringe only if (1) consumer testing and evaluation of the product is an ordinary and necessary business expense (other than as compensation) of the employer, (2) business reasons necessitate that the testing and evaluation be performed off-premises by employees (i.e., the testing and evaluation cannot be carried out adequately in the employer's office or in laboratory testing facilities), (3) the item is furnished to the employee for purposes of testing and evaluation, (4) the item is made available to the employee for no longer than necessary to test and evaluate its performance, and the item must be returned to the employer at completion of the testing and evaluation period, (5) the employer imposes limitations on the employee's use of the item which significantly reduce the value of any personal benefit to the employee, and (6) the employee must submit detailed reports to the employer on the testing and evaluation. The fifth requirement above is satisfied, for example, if (i) the employer places limitations on the employee's ability to select among different models or varieties of the consumer product which is furnished for testing and evaluation purposes, (ii) the employer's policy provides for the employee, in appropriate cases, to purchase or lease at his or her own expense the same type of item as that being tested (so that personal use by the employee's family will be limited), and (iii) the employer requires that members of the employee's family generally cannot use the item. Gross income does not include the fair market value of personal use of such consumer goods provided to an employee primarily for such product testing and evaluation which does not qualify under the requirements above to the extent that the employee pays or reimburses the employer for the fair market value of such personal use.

If products are furnished under a testing and evaluation program only to officers, owners, or highly compensated employees, this fact may be considered in a determination of whether the goods are furnished for testing and evaluation purposes or for compensation purposes, unless the employer can show a business reason for the classification of employees to whom the products are furnished (e.g., that automobiles are furnished for testing and evaluation by an automobile manufacturing company to its design engineers and supervisory mechanics.) The product testing rule described above does not provide any exclusion with respect to testing and evaluation of services, or products other than consumer goods.

Employee parking

Under a special rule in the Act, the fair market value of free or reduced-cost parking provided to an employee on or near the business premises of the employer is excludable as a working condition fringe.[85] This special employee parking rule is not subject to the nondiscrimination rules applicable to certain other excludable benefits under the Act.

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[85] Since the Act expressly provides that the providing of such parking constitutes a working condition fringe, the general requirement otherwise applicable for exclusion as a working condition fringe—that payment for the property or services would have been deductible by the employee under sec. 162 had the employee paid for the property or services—is not applicable with respect to the special parking rule.

Demonstration use by full-time auto salespersons

Under a special rule in the Act, the fair market value of any use of an employer-provided automobile by a full-time automobile salesperson in the geographic sales area in which the dealer's sales office is located is an excludable from income and wages as a working condition fringe if (1) such use of the car is provided primarily for the purpose of facilitating the salesperson's performance of services for the employer, and (2) there are substantial restrictions on the personal use of the car by the salesperson. For example, if an auto salesperson is required to have a car available for showing to customers during working hours, is required to drive the make of car which the auto dealer sells, is limited in the amount of miles he or she may drive the car, may not store personal possessions in the car, and is prohibited from using the car for vacation trips, then use of the car in the described sales area qualifies as a working condition fringe under the Act. This provision is not available to any persons other than full-time automobile salespersons, such as part-time salespersons, mechanics, the dealer's bookkeeper, managers, or officers (other than full-time automobile salespersons).

e. De minimis fringe (sec. 531(a) of the Act and new Code sec. 132(e))

General rules

Under the Act, if the fair market value of any property or service that otherwise would be includible in gross income of any person is so small that accounting for the property or service would be unreasonable or administratively impracticable, the value is excluded for income and employment tax purposes. The Act provides that the frequency with which similar fringe benefits (otherwise excludable as de minimis fringes) are provided to such person is to be taken into account, among other relevant factors, in determining whether the fair market value of the property or service is so small as to make accounting for the property or service unreasonable or administratively impracticable.

The nondiscrimination rules applicable to certain other provisions of the Act do not apply as a condition for exclusion of property or a service as a de minimis fringe, except for subsidized eating facilities (as described below).

To illustrate, benefits that generally are excluded from income and employment taxes as de minimis fringes include the occasional typing of personal letters by a company secretary, occasional personal use of the company copying machine,[86] transit passes or tokens provided at discounts not exceeding a total of $15 per month (i.e., not exceeding a cumulative total discount of $180 per year), occasional company cocktail parties or picnics for employees, occasional supper money or taxi fare because of overtime work, tradi-

[86] For this purpose, it is intended that where an employer exercises sufficient control and imposes significant restrictions over personal use of a copying machine such that substantially all (at least 85 percent) of the use of the machine can be shown by the employer to be for business purposes, the employer may treat as a de minimis fringe any personal use of that machine by a particular employee which might occur.

tional gifts on holidays of tangible personal property having a low fair market value (e.g., a turkey given for the year-end holidays), occasional theatre or sporting event tickets, and coffee and doughnuts furnished to employees. However, the frequency with which any such benefits are offered may make the exclusion unavailable for that benefit, regardless of difficulties in accounting for the benefits. By way of illustration, the exclusion is not available if traditional holiday gifts are provided to employees each month, or if sandwiches are provided free-of-charge to employees on a regular basis.

Subsidized eating facilities

If an employer provides and operates[87] an eating facility for its employees on or near the employer's business premises and if revenue derived from the facility normally equals or exceeds the direct operating costs of the facility, the excess of the fair market value of a meal over the fee charged to the employee for such meal is excluded from income and wages under the Act as a de minimis fringe. Although the benefits provided to a particular employee who eats regularly at such a facility may not qualify as a de minimis fringe absent this rule, the recordkeeping difficulties involved in identifying which employees ate which meals on particular days, as well as the values and costs for each such meal, led the Congress to conclude that an exclusion should be provided for subsidized eating facilities as defined in the Act.

While in general the nondiscrimination rules of the Act do not apply with respect to a de minimis fringe, the special exclusion for subsidized eating facilities applies to an officer, owner, or highly compensated employee only if access to the facility is available on substantially the same terms to each member of a group of employees which is defined under a reasonable classification set up by the employer which does not discriminate in favor of officers, owners, or highly compensated employees (see description below of nondiscrimination rules).

Free meals provided on an employer's premises to employees for the convenience of the employer are excludable from income to the extent provided by section 119, which was not amended by this Act.

f. Athletic facilities (sec. 531(a) of the Act and new Code sec. 132(h)(5))

In general, the fair market value of any on-premises athletic facility provided and operated[88] by an employer for its employees, where substantially all the use of the facility is by employees of the employer, spouses of employees, and dependent children of employees,[89] is excluded under the Act for income and employment tax

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[87] For purposes of this provision, an employer is considered as operating the eating facility if the employer itself operates the facility through its own employees, or if the employer contracts out the actual operation (food purchasing, preparation, service, etc.) to a food service business.

[88] For purposes of this provision, an employer is considered as operating athletic facilities located on its premises if the employer itself operates the facilities through its own employees, or if the employer contracts out the actual operation (e.g., maintenance and supervision of exercise equipment) to an outside business.

[89] For this purpose, the term dependent child has the same meaning as in new Code sec. 132(f).

purposes. The athletic facility need not be at the same location as the business premises of the employer, but must be located on premises of the employer and may not be a facility for residential use. Examples of athletic facilities are swimming pools, gyms and exercise rooms, tennis courts, and golf courses.

The special exclusion for certain employer-provided athletic facilities does not apply to the providing of memberships in a country club or similar facility (unless, of course, the facility itself is provided and operated by the employer and satisfies the requirements of this provision for the special exclusion). Thus, where no exclusion is available under this provision, the fair market value of such benefits is includible in income and wages of the employee who is provided with membership or uses the facility. (In limited circumstances, where the costs of such benefits would have been deductible under section 162 by the employee had the employee paid for them and where such deduction would not have been disallowed under section 274, such benefits may be excludable as a working condition fringe.)

A nondiscrimination requirement is not provided in the Act as a condition for this exclusion, because Code section 274 denies a deduction to the employer for costs attributable to a facility which is primarily for the benefit of officers, owners, or highly compensated employees.

g. Qualified tuition reductions (sec. 532 of the Act and Code sec. 117)

The Act adds a new provision to Code section 117 (relating to scholarships and fellowship grants) to exclude, for income and employment tax purposes, the amount of qualified tuition reductions, including cash grants for tuition, provided to an employee of an educational institution (as defined in Code sec. 170(b)(1)(A)(ii)).[90] This new provision supersedes, as of the effective date of the provision, the existing Treasury regulation relating to tuition remission (Reg. sec. 1.117-3(a), last sentence).

The exclusion applies generally to tuition reductions for education at the elementary, secondary, or undergraduate levels.[91] The general exclusion for qualified tuition reductions (below the graduate level) applies whether the education is at the employer educational institution or at another educational institution. This general exclusion applies for qualified tuition reductions provided for the education of (1) an individual who is currently an employee of the educational institution; (2) an individual who formerly was em-

[90] An educational organization is described in sec. 170(b)(1)(A)(ii) "if its primary function is the presentation of formal instruction and it normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils of students in attendance at the place where its educational activities are regularly carried on. The term includes institutions such as primary, secondary, preparatory, or high schools, and colleges and universities", and includes both public and private schools (Reg. sec. 1.170A-9(b)(1)).

[91] Under P.L. 98-611, solely for the period beginning January 1, 1984, and ending December 31, 1985 (the date on which section 127 is scheduled to terminate), otherwise qualified tuition reductions for education above the undergraduate level are excluded in the case of an individual who is a graduate student at an educational institution (described in sec. 170(b)(1)(A)(ii)) and who is engaged in teaching or research activities for such educational institution. For the legislative background of P.L. 98-611, *see* H. Rep. No. 98-1049.

ployed by the educational institution and who separated from service with the employer by reason of retirement or disability; (3) a widow or widower of an individual who died while employed by the educational institution; or (4) a widow or widower of a former employee of the institution who had separated from service with the employer by reason of retirement or disability. Also, the tuition reduction may be provided for the education of the spouse or a dependent child of an individual described in the previous sentence.[92]

The qualified tuition reduction provision of the Act applies with respect to education furnished after June 30, 1985. The Congress intended that present practice with respect to the tax treatment of tuition reduction provided to employees of educational institutions is to remain unchanged until this provision is effective.[93]

h. Nondiscrimination rules

Under the Act's provisions relating to no-additional-cost services, qualified employee discounts, subsidized eating facilities, and qualified tuition reductions, the exclusion for such a benefit is available to an officer, owner, or highly compensated employee (the "highly compensated group") only if the benefit is available on substantially the same terms to each member of a group of employees which is defined under a reasonable classification set up by the employer that does not discriminate in favor of the highly compensated group.

If the availability of the fringe benefit does not satisfy these nondiscrimination rules, the exclusion applies only to those employees (if any) receiving the benefit who are not members of the highly compensated group. For example, if an employer offers a 20-percent discount (which otherwise satisfies the requirements for a qualified employee discount) to rank-and-file employees and a 35-percent discount to the highly compensated group, the entire value of the 35-percent discount (not just the excess over 20 percent) is includible in gross income and wages of the members of the highly compensated group who make purchases at a discount.

The determinations of whether a particular classification is a reasonable classification and whether the classification discriminates in favor of the highly compensated group depend on the facts and circumstances involved. A classification that, on its face, makes benefits available only to officers, owners, or highly compensated employees (or to all such members of the highly compensated group) is per se discriminatory, and no exclusion is available to any member of the highly compensated group for the fair market value of such benefits. On the other hand, an employer could establish a classification that is based on certain appropriate factors, such as seniority, full-time vs. part-time employment, or job description, provided that the effect of the classification is nondiscriminatory. A determination that a classification is reasonable and nondiscriminatory for purposes of applying the nondiscrimination rules of sec-

[92] For this purpose, the term dependent child has the same meaning as in new Code sec. 132(f).

[93] As stated in note 91, *supra*, the special rule enacted in P.L. 98-611 with respect to tuition reduction at the graduate level for certain individuals applies for the period beginning January 1, 1984, and ending December 31, 1985.

tion 531 and 532 of the Act is not to be taken as an indication as to whether or not the classification is reasonable or nondiscriminatory for purposes of applying other nondiscrimination rules in the Code, such as the rules in section 401(a)(4) for qualified pension plans.

One example of a fringe benefit to which the nondiscrimination rules apply is the providing by retail stores of certain discounts to employees and their spouses. Suppose that a store makes this benefit available only to executives and salespersons, but not to employees in other categories, such as clerical and maintenance employees. To determine whether such a classification would be discriminatory in this particular case, all employees of the store would be divided into categories according to their level of compensation. If the number of the most highly compensated employees to whom the benefit is available, as a proportion of all employees in that category, were not substantially higher than the corresponding proportions for the remaining categories of employees, then the classification would not be considered to be one that discriminated in favor of the highly compensated group.

For purposes of the nondiscrimination rules, the determination of which employees are highly compensated would depend on the facts and circumstances of the particular situation, but could rely on any guidelines prescribed by the Treasury Department for this purpose. Examples of such guidelines could be that employees with compensation above, for example, a specific percentile in the employer's compensation distribution or above, for example, a specific annual rate, or both, are to be treated as highly compensated. Such guidelines could vary by industry and could reflect unique characteristics of particular employers or particular industry categories of employment. Any failure of the Treasury Department to issue such guidelines shall not in any way affect application of the nondiscrimination rules as of the effective date for new Code section 132. It is intended that, insofar as practicable, the Internal Revenue Service is to issue advance determinations as to whether the nondiscrimination requirements of the Act are met in the case of employers (such as nonprofit organizations) to which similar requirements in other sections of the Code have not regularly been applied.

The nondiscrimination rules do not apply to a working condition fringe or a de minimis fringe (other than subsidized eating facilities). For example, if the fair market value of security protection provided by an employer only to its executives otherwise qualifies for exclusion as a working condition fringe, the exclusion applies even though the availability of the benefit would not satisfy the nondiscrimination rules applicable under the Act to other fringe benefit exclusions.

i. Other rules

Definition of employer

For purposes of new Code section 132, all employees of all corporations that are members of a controlled group of corporations (within the meaning of Code sec. 414(b)), all employees of all trades or businesses (whether or not incorporated) under common control (sec. 414(c)), or all employees of an affiliated service group (sec. 414(m)) are treated as employed by a single employer. Consequently, if a chain of retail hardware stores separately incorporates each hardware store as a wholly owned subsidiary of one corporation, the employees of one subsidiary may receive qualified employee discounts from stores operated by the other subsidiaries, since all such hardware stores are in the same line of business.

However, the aggregation of commonly controlled, etc., employers does not change the other requirements for an exclusion. For example, if a controlled group of corporations consists of two corporations whose products are in different industry groups, the aggregated entities are not considered as consisting of a single line of business even though the two corporations are treated as one employer. Thus, an employee discount received by an employee of one such corporation on the purchase of goods from the other corporation in the controlled group does not qualify for the exclusion, since the discount is not provided on goods sold in the same line of business as that in which the employee performs services.

The nondiscrimination rules also are applied under the Act by aggregating such related employers, but without aggregating employees in different lines of business (as defined above in the descriptions of the exclusions for no-additional-cost services and qualified employee discounts).

Nonapplicability to certain fringe benefits

The Act expressly provides that a benefit is not excludable under new Code section 132 (unless it qualifies as a de minimis fringe) if another section of the Internal Revenue Code provides rules for the tax treatment of that general type of benefit. For example, the fair market value of day care services provided to an employee is excludable only pursuant to the provisions of Code section 129. If in a particular situation such services do not qualify for exclusion under section 129 (e.g., because the nondiscrimination requirements of that section are not met), no exclusion is available under the Act (except to the extent that occasional use of employer-provided day care services might qualify as a de minimis fringe).

Correspondingly, the provisions of section 132 do not modify any of the prior-law statutory exclusions (except to the extent that the Act modifies the definition of cafeteria plans under sec. 125 and amends sec. 117).[94] For example, Code section 119 excludes from the gross income of an employee the value of meals furnished on the employer's business premises for the convenience of the employer. Under Treasury regulations, meals provided free of charge are treated as furnished for the employer's convenience if the meals are furnished for a substantial noncompensatory business reason of the employer. For example, the regulations state that on-premises meals satisfy this requirement if furnished so that the employee is available for emergency calls during meal periods, if employees are restricted to a short meal period which precludes eating out, or if there are insufficient eating facilities in the vicini-

[94] Under the Act, neither the section 132 exclusion nor the section 117 exclusion is available if the employer offers employees a choice between (1) the benefits described in such exclusion and (2) cash or any other form of compensation that is taxable.

ty (Treas. Reg. sec. 1.119-1(a)). The Act does not affect the exclusion provisions of section 119.

j. Treasury regulations; taxable benefits (sec. 531 of the Act, secs. 61, 3121, 3231, 3306, 3401, and 3501 and new sec. 132(k) of the Code, and sec. 209 of the Social Security Act)

Treasury regulations

The Act expressly provides that the Treasury Department is to prescribe such regulations as may be necessary or appropriate to carry out the purposes of new Code section 132.

It is intended that any such Treasury regulations are to be consistent with the language of the Act and with the legislative history of the Act as reflected in pertinent portions of the Explanatory Statement of the Committee on Conference (H. Rpt. No. 98-861) and of the Supplemental Report of the Committee on Ways and Means on H.R. 4170 (H. Rpt. No. 98-432, pt. 2), taking into account modifications made by the conference agreement on the Act to the bill as reported by the Committee on Ways and Means. Thus, any example of a fringe benefit which such legislative history explicitly states is excluded under the Act from income and wages is to be so treated in any regulations.

Taxable benefits

As a clarification that the fair market value of any fringe benefit not covered by an express statutory exclusion is included in the recipient's gross income, the Act amends Code section 61(a) to provide that fringe benefits are among the items specifically listed in that section as included in gross income. Similar statutory modifications are made to the definition of wages or compensation for purposes of FICA taxes (sec. 3121(a)(1)), FUTA taxes (sec. 3306(b)(1)), railroad retirement taxes (sec. 3231(e)), and withholding (sec. 3401(a)(1)), and the social security benefit base (sec. 209 of the Social Security Act).

Accordingly, any benefit that does not qualify for exclusion under the Act or under another specific statutory benefit provision is includible in gross income for income tax purposes, and subject to income tax withholding and employment taxes, at the excess of its fair market value over any amount paid by the employee for the benefit, both where the employer itself produces the goods or services and where the employer purchases or otherwise acquires the benefits provided to its employees. The fair market value of a benefit may be substantially greater than the cost to the employer of providing the benefit. (Of course, the inclusion of the fair market value amount in the employee's income does not allow the employer to deduct any amount in excess of the employer's cost of providing the benefit.) Thus, for purposes of assisting both taxpayers and the Internal Revenue Service, the Treasury is to issue regulations, as soon as practicable and to the extent feasible, setting forth appropriate and helpful rules for the valuation of taxable fringe benefits, and coordinating the applications of sections 61 and 83.

The Congress was aware that noncash remuneration generally was subject to FICA, FUTA, and income tax withholding under prior law. It is intended that, in order to reflect the provisions of the Act, any existing regulations and rulings under these employment tax provisions are to be modified as necessary to make clear that, in the absence of an express statutory exclusion, remuneration for employment should not be exempt from these employment taxes merely because it is paid in the form of property or services rather than cash. Since the statutory term "remuneration" is to be interpreted broadly to include compensation for services which have been performed, noncash benefits (such as the fair market value of personal use by an employee of a company-owned car, or allowances for meals when the employee is not away from home overnight) which are not excluded under the provisions of this Act or other specific statutory provisions are to be subject to these employment taxes. This broad interpretation of remuneration is especially important in the case of FICA, for which withholding is generally the only collection method available.

The Act expressly provides that any employment taxes (including withholding) imposed by the Code with respect to noncash fringe benefits shall be collected (or paid) by the employer at the time and in the manner prescribed by Treasury regulations. To the maximum extent practicable, such regulations may provide for collection (or payment) of FICA taxes under sections 3101 and 3111 with respect to noncash fringe benefits in a calendar quarter not later than the time for collection (or payment) of such taxes on cash wages paid on the last day of that quarter. The regulations may provide similar rules for other employment taxes.

The Congress was informed that under established practices in certain industries, employers may make available to employees damaged, distressed, or returned goods at a price which equals or exceeds the fair market value of such items but which may be less than the cost to the employer of the items before being damaged, etc. In such situations, no amount is to be includible in the employee's income where the purchase price paid by the employee equals or exceeds the fair market value of the item.

Under existing Code provisions and section 61 regulations, benefits to military personnel such as subsistence, housing, and uniform allowances are excludable from income (see Treas. Reg. sec. 1.61-2(b)). Section 531 of the Act does not make any change in existing excludable military benefits. Thus, for example, the value of discounts at military commissaries is to be considered as provision of subsistence under existing regulations and fully excludable without regard to the Act.

k. Faculty housing (sec. 531(g) of the Act and sec. 61 of the Code)

The Act prohibits the Treasury Department from issuing, prior to January 1, 1986, any income tax regulations under Code section 61 that would provide for inclusion in gross income of the excess of the fair market value of qualified campus lodging over the greater of (1) the operating costs paid in furnishing the lodging or (2) the rent received. This moratorium on regulations applies only with respect to qualified campus lodging furnished to the employee after December 31, 1983 and before January 1, 1986.

The term qualified campus lodging means lodging furnished by an educational institution (within the meaning of sec.

170(b)(1)(A)(ii))[95] to any employee of the educational institution or to the employee's spouse or dependents (within the meaning of sec. 152), including nonfaculty employees. The moratorium applies only with respect to employer-furnished lodging that is located on a campus of, or in close proximity to a campus of, the educational institution.

Under the Act, the moratorium does not apply with respect to any amount of the value of lodging if such amount was treated as wages or included in income when furnished.

Effective Dates

In general, these provisions of the Act take effect on January 1, 1985.

The exclusion for qualified tuition reductions (Act sec. 532) applies with respect to education furnished after June 30, 1985.

The moratorium with respect to qualified campus lodging (Act sec. 531(g)) applies only with respect to lodging furnished after December 31, 1983, and before January 1, 1986. No inference is intended by imposition of a moratorium for such period as to the proper income tax treatment of faculty housing furnished prior to 1984 or after 1985.

Revenue Effect

Sections 531(a), 531(c)-(g), and 532 of the Act are estimated to have a negligible effect on budget receipts.

[95] See note 90, *supra*.

2. Cafeteria Plans (sec. 531 of the Act and sec. 125 of the Code)[96]

Prior Law

Under prior law, the cafeteria plan rules of the Code provided that a participant in a nondiscriminatory cafeteria plan was not treated as having received a taxable benefit offered under the plan solely because the participant had the opportunity, before the benefit became available to the participant, to choose among the taxable and nontaxable benefits offered under the plan. The term "taxable benefit" included cash, property, and other benefits that were currently taxable to the participant upon receipt. A "nontaxable benefit" was any benefit that was not currently taxable to the participant upon receipt (e.g., group-term life insurance coverage up to $50,000, coverage under an accident or health plan, or coverage under a dependent care assistance program).

A highly compensated participant in a cafeteria plan is treated as having received available cash and taxable benefits if the cafeteria plan discriminates in favor of highly compensated individuals as to eligibility or as to benefits or contributions. A highly compensated individual includes an officer, a 5-percent shareholder, a highly compensated individual, or a spouse or dependent of any of the preceding individuals. A cafeteria plan is not treated as discriminatory if the plan is maintained pursuant to an agreement that the Secretary finds to be a collective bargaining agreement between employee representatives and one or more employers. Certain special rules are provided for purposes of determining whether health benefits provided under a cafeteria plan are provided on a nondiscriminatory basis.

A cafeteria plan could not offer either vanpooling, educational assistance, or any benefit that deferred the receipt of compensation (other than the opportunity for participants to make elective contributions under a qualified cash or deferred arrangement).

The cafeteria plan rules generally do not affect whether any particular benefit offered under the plan is a taxable or nontaxable benefit. Thus, a benefit that is nontaxable under the Internal Revenue Code when offered separately is a nontaxable benefit under a cafeteria plan only if the rules providing for the exclusion of the benefit from gross income continue to be satisfied when the benefit is provided under the cafeteria plan.

On February 10, 1984, the Internal Revenue Service issued a news release (IR-84-22), which stated that so-called "flexible spending arrangements" offered as part of cafeteria plans do not provide employees with nontaxable benefits under the Code because, under

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[96] For legislative background, see: committee amendment to H.R. 4170, approved by the House Committee on Ways and Means on March 1, 1984, sec. 502; H Rept. No. 98-432, Pt. 2 (March 5, 1984), pp. 1608-9; H. Rep. No. 98-861 (June 23, 1984), pp 1173-77 (Conference Report).

such arrangements, employees are assured of receiving the benefit of what they would have received had no covered expenses been incurred. A flexible spending arrangement consists of a benefit of a type to which a statutory exclusion may be applied, such as an accident or health plan under sections 105 and 106, with respect to which an employee is assured of receiving amounts available for expense reimbursement without regard to whether the employee incurs the covered expenses.

In May 1984, the Internal Revenue Service issued proposed regulations (49 F.R. 19321, May 7, 1984) with respect to the cafeteria plan rules and to the statutory rules relating to the exclusion of benefits from gross income. The proposed regulations provided that an otherwise nontaxable benefit will be nontaxable if offered in a cafeteria plan only if it continues to satisfy the requirements for its exclusion from gross income. Accordingly, under the proposed regulations employer contributions with respect to an accident or health plan, a qualified group legal services plan, or a dependent care assistance program are not excluded from a participant's gross income under the Internal Revenue Code to the extent that the participant is assured of receiving benefits under the plan or program without regard to whether the participant incurred covered expenses.

Reasons for Change

The Congress was aware that the prior-law rule permitting taxable benefits to be provided under a cafeteria plan generated some confusion among taxpayers who thought that all benefits, other than cash, provided under a cafeteria plan were nontaxable benefits. In addition, the Congress was concerned with the additional potential for erosion of the income and employment tax bases that could occur with the greater flexibility a wider array of benefits provided. Thus, the Congress found it appropriate to limit the permissible cafeteria plan benefits to cash and certain benefits that are excluded from gross income by specific provisions of the Code.

In addition, the Congress believed that the prior-law nondiscrimination rules were inadequate to prevent a significant amount of cafeteria plan benefits from being provided to key employees of an employer. The Congress considered it appropriate to limit the tax benefits available to key employees under certain cafeteria plans.

The Congress was aware that too little data is available with respect to the use and operation of cafeteria plans, including the amount of taxable and nontaxable benefits provided. The Congress believed that all employers maintaining cafeteria plans should be required to file annual information returns and that it was appropriate to give the Treasury the authority to require additional information from a statistically valid sample of employers.

Finally, the Congress was aware that considerable confusion existed concerning the application of the cafeteria plan rules and that some employers, who acted in good faith in establishing cafeteria plans, were adversely affected by the proposed regulations relating to cafeteria plans. The Congress believed that a delay in the application of rules corresponding to those set forth in the proposed regulations would be appropriate.

Explanation of Provision

In general

The Act redefines a cafeteria plan as a plan under which employees may choose (1) taxable benefits consisting of cash or certain other taxable benefits, or (2) certain fringe benefits that are specifically excluded from gross income by the Code (statutory fringe benefits).

Taxable benefits

Under the Act, the only taxable benefits which may be offered in a cafeteria plan consist of certain life insurance coverage that is not excludable from gross income, certain vacation pay, or cash. The life insurance coverage that may be offered is the coverage that is included in gross income to the extent the coverage exceeds $50,000 or to the extent it is provided on the life of a spouse or dependent of an employee. Vacation days may be provided under a cafeteria plan only if the plan precludes any participant from using (or receiving cash for) vacation days remaining unused as of the end of the plan year.

The taxable benefit which is offered under a cafeteria plan generally need not be cash. For example, a cafeteria plan could provide an employee with a choice between (1) coverage by a dependent care program and (2) group-term life insurance that would be excludable except that the coverage exceeds $50,000. On the other hand, a cafeteria plan that permits an employee to make an elective deferral under a profit-sharing or other plan with a qualified cash or deferred arrangement is required, because of the rules governing those arrangements, to permit an employee to choose an amount of cash that is not less than the amount that may be deferred.

Nontaxable benefits

A cafeteria plan may offer any fringe benefit (other than scholarships or fellowships, vanpooling, educational assistance, or miscellaneous fringe benefits) that is excludable from gross income under a specific section of the Code. Under the Act, a benefit that is derived from employee contributions is tested under the same rules that would apply if there were no such contributions. Accordingly, a cafeteria plan may not provide a benefit that is otherwise impermissible, whether or not the benefit is paid for by employee contributions, and, conversely, the plan may provide a benefit that would be nontaxable if employee contributions were less than the fair market value of the benefit.

Benefits for key employees

Under the Act, if more than 25 percent of the total nontaxable benefits provided under a cafeteria plan for a plan year are provided to employees who are key employees with respect to the plan for such year (as determined under the rules of sec. 416(i)(1)), such key employees will be taxed as though they received all available taxable benefits under the plan. Generally, in determining the portion of the total nontaxable benefits that is provided to key employees, the value of coverage under a plan (e.g., an accident or health plan) and not actual expense reimbursements under such a plan are to be counted.

Reporting requirement

The Act applies certain reporting requirements with respect to cafeteria plans. Under regulations prescribed by the Treasury, each employer that maintains a cafeteria plan during a taxable year beginning after December 31, 1984, will be required to file a return for such year showing the number of employees of the employer, the number of employees participating in the plan, the total cost of the plan for the taxable year, and specified employer identification information.

Based on these general returns, the Treasury is to require a select and statistically significant group of employers to file additional information returns with respect to their cafeteria plans. These additional returns will contain such information as the Treasury may require. Examples of such information include a breakdown of the above information by salary range and type of benefit provided, as well as information which may be necessary to allow Treasury to develop a plan to insure that the requirements of the cafeteria plan rules (such as nondiscrimination and maximum percentage of benefits to key employees) are adequately enforced.[97]

Transition rules

Under the Act, both general and special transition relief is provided with respect to the Treasury regulations on cafeteria plans, for cafeteria plans and "flexible spending arrangements" in existence on February 10, 1984.

The general relief rule provides that a plan will not fail to be a cafeteria plan merely because of a failure to satisfy the rules relating to cafeteria plans under the Treasury regulations and that a flexible spending arrangement will not fail the requirements of the applicable statutory exclusions merely because of a failure to satisfy the rules relating to such exclusions under these regulations. This general relief is provided until the earlier of January 1, 1985, or the effective date of any modification of the plan or arrangement to provide additional benefits if such modification becomes effective after February 10, 1984. The Act does not prevent the application of Treasury regulations relating to cafeteria plans after the earlier of such dates.

Thus, for example, if on February 10, 1984, a flexible spending arrangement providing accident or health benefits failed to satisfy the rules relating to accident or health plans under the Treasury regulations and thereafter continues to fail such rules because such arrangement provides for the allocation of amounts to a benefit account only after the expense is incurred, such arrangement will be treated as qualifying as an accident or health plan until the earlier of the two dates provided above.

The general transition rule is applicable to both benefit bank flexible spending arrangements and zero balance reimbursement

[97] These reporting requirements were consolidated with similar requirements provided for educational assistance programs and for group legal service plans in P.L. 98-611 and P.L. 98-612, respectively.

account (ZEBRA) type flexible spending arrangements. Under a benefit bank arrangement, the employee generally allocates a specified amount of dollars to a reimbursement account for specified benefits, e.g., medical, legal, and dependent care, at the beginning of the plan year. As expenses are incurred during the year, the employee is entitled to reimbursement of these expenses from the account. For example, if an employee with $500 allocated to his account incurred medical expenses of $250, he could be reimbursed for these expenses from the account. At the end of the year, he would receive the remaining $250 in cash. In contrast, under the ZEBRA-type arrangement, amounts generally are not specifically allocated to an account before the beginning of the year, but instead amounts are allocated only after an expense in incurred.

The Act also provides special transition relief with respect to the rules contained in the Treasury regulations relating to certain statutory nontaxable benefits provided under certain flexible spending arrangements. This relief provision provides that any benefit offered under a cafeteria plan in existence on February 10, 1984, will not fail to be a nontaxable benefit under the exclusions applicable to accident and health plans, group legal services plans, or dependent care assistance programs merely because a participant will receive amounts available but unused for expense reimbursement. An arrangement will qualify for the special relief only if, under the arrangement, the employee must fix the amount of contributions to be made on his or her behalf before the beginning of the applicable period of coverage and taxable cash is not available before the end of such period or, if earlier, at the termination of employment. In lieu of distributing taxable cash to a participant at the end of the applicable period of coverage, it would also be permissible for the unused amounts to be carried over to the succeeding year. Further, an arrangement could permit a participant to terminate contributions during the period of coverage or to change the rate or amount of contributions during the period of coverage on account of certain changes in family status or change in employment status from full-time to part-time, or vice versa.

This special transition relief will be available to arrangements that, on February 10, 1984, and thereafter, failed to satisfy these restrictions if such arrangements are modified, before January 1, 1985, to comply with such restrictions. The special relief under this rule is for benefits provided before the earlier of July 1, 1985, or the effective date of any modification of the arrangement to provide additional benefits if such modification becomes effective after February 10, 1984. The Act does not prevent the application of Treasury regulations after the earlier of the applicable dates.

Cafeteria plans and flexible spending arrangements that were not in existence on February 10, 1984, generally do not qualify for either the general or the special transition rules under the Act. Thus, the Act does not prevent the current application of Treasury regulations to such plans and arrangements. However, plans that were not actually in existence as of February 10, 1984, but with respect to which substantial implementation costs had been incurred by the employer by such date are to be treated as having been in existence on such date. If an employer has incurred, as of February 10, 1984, either more than $15,000 of implementation costs or more than one-half of the total costs of implementing a cafeteria plan, the transition rules are to be available with respect to the cafeteria plan. In making this determination, total implementation costs are the costs of designing and installing computer programs for operation of the plan and the costs of printing cafeteria plan brochures for employees. Costs associated with more than one plan of the same employer are to be allocated among the plans on the basis of the number of participants in the plans.

Finally, the Act provides that the Secretary of Health and Human Services, in cooperation with the Secretary of the Treasury, is to submit a report to the House Committee on Ways and Means and the Senate Committee on Finance on the effect of cafeteria plans on the containment of health costs. This report is to be submitted by April 1, 1985. The study is to examine the impact which the use of cafeteria plans (including flexible spending arrangements) has on the containment of health care costs and to recommend what modifications might be desirable with respect to the cafeteria plan rules to optimize the potential to reduce medical costs while balancing against other health care policy goals. Included within the study should be an analysis of the advisability of establishing Federal guidelines relative to the type of medical plans that can qualify for cafeteria plan treatment in a manner similar to that applicable to qualified pension plans and the advisability of adding additional benefits to cafeteria plans.

Effective Date

Unless otherwise provided, the provision generally is effective on January 1, 1985. However, it is intended that the 25-percent key employee test and the restriction of benefits to "statutory nontaxable benefits" are to apply to plan years beginning after December 31, 1984.

Revenue Effect

The provision is estimated to reduce fiscal year receipts by $32 million in 1984, $40 million in 1985, and $4 million in 1986.

D. Employee Stock Ownership Provisions

(Secs. 541-545 of the Act and sec. 404, and new secs. 133, 1042, 2210, and 4978 of the Code)[98]

Prior Law

In general

An employee stock ownership plan ("ESOP") is a qualified stock bonus plan or a combination stock bonus and money purchase pension plan which may be utilized as a technique of corporate finance and 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 (or trusts). Gain realized on the sale of employer securities to an ESOP is generally taxed at capital gain rates.

Deduction limits

An ESOP that borrows to acquire employer stock is referred to as a leveraged ESOP. Under a leveraged ESOP, amounts contributed by the employer and applied by the plan to the payment of interest on a loan incurred to purchase employer securities are deductible within limits. Under prior law, no deduction was permitted for dividends paid with respect to stock held by the ESOP.

Distributions

In general, a qualified stock bonus plan may distribute amounts attributable to employer contributions only after a fixed number of years, the attainment of a stated age or upon the prior occurrence of an event such as a layoff, illness, disability, retirement, death, or separation from service. Amounts that are to be distributed after a fixed number of years must be held in trust for at least two years.

In a tax credit ESOP, further restrictions apply. In general, employer securities allocated to an employee's account under a tax credit ESOP generally may not be distributed before the end of the 84th month after the month in which the securities are allocated.

If a stock bonus plan contains a qualified cash-or-deferred arrangement, amounts attributable to elective contributions and certain nonelective contributions under that arrangement may be distributed only upon retirement, death, disability, hardship, or the attainment of age 59 1/2 and may not be distributed merely by reason of the completion of a stated period of service or the lapse of a fixed number of years. Similarly, a qualified money purchase

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[98] For legislative background of the provision, see "Deficit Reduction Act of 1984", as reported by the Senate Committee on Finance on March 21, 1984, secs. 101-108; S. Prt. 98-169, Vol. 1 (April 2, 1984) pp. 331-336, H. Rep. 98-861 (June 23, 1984), pp. 1181-1184 (Conference Report).

pension plan may not distribute benefits before (1) the employee retires or otherwise separates from service, (2) the employee becomes disabled or dies, or (3) the plan terminates.

Certain ESOP distributions of dividends payable with respect to qualifying employer securities are permitted prior to the time the plan would otherwise be permitted to make distributions. Thus, dividends paid with respect to qualifying employer securities allocated to a participant's account under a stock bonus ESOP may be immediately distributed in cash. Similarly, dividends paid with respect to qualifying employer securities allocated to a participant's account under a money purchase ESOP may be immediately distributed in cash. These ESOP distributions of dividends are treated as plan distributions, and are not eligible for the dividends paid exclusion of section 116.

Estate tax liability for closely held businesses

If the value of the interest in a closely held business exceeds 35 percent of the value of a decedent's adjusted gross estate, then the estate taxes attributable to the value of that interest may be paid in installments for up to 14 years (annual interest payments for four years, followed by up to ten annual installments of principal and interest).[99] With respect to estate taxes on the first $1 million of value of an interest in a closely held business,[100] a special four-percent interest rate applies.

In general, the payment of any unpaid tax is accelerated upon notice and demand from the Secretary of the Treasury if there is a failure to pay timely any installment of interest or tax or if cumulative dispositions and withdrawals from the business exceed 50 percent of the decedent's interest.

Certain transfers of an interest in a closely held business from the decedent are not considered to be a disposition. Transfers qualifying for this exception are those (1) from the decedent to a person entitled by reason of the decedent's death to receive such property under the decedent's will, the applicable laws of descent and distribution, or a trust created by the decedent, or (2) from an heir (or subsequent transferee) at his death to a family member of the heir (or subsequent transferee).

Under prior law, an ESOP could not assume the estate tax liability with respect to stock of a closely held business which was transferred to the ESOP.

Reasons for Change

The Congress believed that alternative tax incentives, applicable with respect to both tax credit ESOPs and leveraged ESOPs, are important to encourage employee stock ownership.

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[99] Sec. 6166.
[100] Sec. 6601(j).

Explanation of Provisions

1. Tax-free rollover on sale to employees

In general

Under the Act, a taxpayer may elect to defer recognition of gain on the sale of certain qualified securities to an employee stock ownership plan (ESOP) or to an eligible worker-owned cooperative to the extent that the taxpayer reinvests the proceeds in qualified replacement property within a replacement period. To be eligible for nonrecognition treatment, (1) the qualified securities must be sold to an employee organization; (2) the employee organization must own, immediately after the sale, at least 30 percent of the total value of the employer securities then outstanding; (3) the employee organization must preclude allocation of assets attributable to qualified securities to certain individuals; and (4) the taxpayer must provide certain information to the Secretary of the Treasury. To preclude the employee organization from disposing of the qualified securities within three years of the date of the sale, an excise tax measured by dispositions or distributions which reduce the organization's interest in employer securities to less than 30 percent is imposed on the employer maintaining the ESOP or on the eligible worker-owned cooperative.[101] Under the Act, qualified employer securities acquired by an underwriter in the ordinary course of the trade or business as an underwriter (whether or not guaranteed) will not be eligible for this nonrecognition treatment upon sale to an employee organization.

Employee organizations

Nonrecognition treatment is permitted with respect to sales of qualified securities to an employee stock ownership plan (ESOP) (within the meaning of sec. 4975) or to an eligible worker-owned cooperative.

Under the Act, an organization is an eligible worker-owned cooperative if (1) it is an organization described in section 1381, (2) a majority of the membership is comprised of employees of the organization, (3) a majority of its voting stock is owned by members, (4) a majority of its board of directors is elected by the members, each of whom have a single vote, and (5) a majority of the allocated earnings and losses of which are allocated to members on the basis of patronage, capital contributions, or some combination of patronage and capital contributions.

Qualified securities; qualified replacement property

For purposes of this provision, qualified securities are defined as employer securities[102] that (1) are issued by a domestic operating corporation which has no readily tradable securities outstanding, (2) have been held by the seller for more than one year (which, pursuant to Treasury regulations, includes periods otherwise permitted to be "tacked" to the holding period under other Code provisions), and (3) have not been received by the seller as a distribution

[101] Sec. 4948.

[102] Eligible securities must be employer securities within the meaning of sec. 409(l).

from a qualified plan or as a transfer pursuant to an option or similar right to acquire stock granted to an employee by an employer (other than stock acquired for full consideration).

Qualified replacement property (which includes both debt and equity instruments, as defined in sec. 165(g)(2)) consists of securities issued by another domestic corporation which does not, for the corporation's taxable year in which such securities are acquired by the taxpayer seeking nonrecognition treatment, have passive investment income (within the meaning of sec. 1362(d)(3)(D)) exceeding 25 percent of such corporation's gross receipts for that taxable year. Congress intended this provision to require reinvestment in business corporations and not, for example, in a municipal corporation.

To be treated as qualified replacement property, such securities must be acquired within a replacement period beginning on the date three months prior to the date the qualified securities are sold to the employee organization (which may include periods prior to the effective date of this provision) and ending twelve months after the date of such sale. If more than one item of property is purchased during the replacement period, the taxpayer may designate those items that the taxpayer is treating as qualified replacement property. If the taxpayer disposes of property that is designated as qualified replacement property, the taxpayer is to recognize gain on the disposition even though the taxpayer has not disposed of other property acquired during the replacement period that would have been treated as qualified replacement property if the taxpayer had so designated it. In no event may the total gain eligible for nonrecognition treatment under this provision exceed the amount realized on the sale of qualified securities to the employee organization.

The basis of the taxpayer in qualified replacement property acquired during the replacement period is reduced by an amount not greater than the amount of gain realized on the sale of qualified securities to the employee organization which was not recognized pursuant to the election provided by this provision. This requirement is intended to insure that the gain will ultimately be recognized when the replacement securities are disposed of.

Under the Act, if more than one item of qualified replacement property is acquired, an allocation rule is provided to determine the taxpayer's basis in each item. Under the allocation rule, the basis of each item designated as qualified replacement property is reduced by an amount determined by multiplying the total gain eligible for nonrecognition treatment by a fraction. The numerator of the fraction is the cost of the item of replacement property and the denominator is the total cost of all such items.

Thirty percent test

A taxpayer may elect nonrecognition treatment with respect to a sale of qualified securities only if the employee organization owns, immediately after the sale, at least 30 percent of the total value of the employer securities outstanding as of such time.

Subsequent to the sale, the employee organization generally must hold the qualified securities for at least three years. An excise tax is imposed on the employer sponsoring the ESOP or the eligible worker-owned cooperative if, within three years after the sale for which nonrecognition treatment is provided (the nonrecognition transaction), the employee organization disposes of or distributes any qualified securities (whether or not such securities were acquired in the nonrecognition transaction) and (1) the total number of shares held by such employee organization after such disposition or distribution is less than the total number held immediately after the nonrecognition transaction, or (2) except to the extent provided by Treasury regulations, the value of employer securities held by the employee organization after the disposition is less than thirty percent of the total value of all employer securities then outstanding.[103] Although the dilution of the employee organization's interest (e.g., by employer issuance of additional securities) would not trigger imposition of the tax, dispositions or distributions occurring subsequent to the dilution may, as a result of the dilution, be subject to the excise tax. The tax is generally equal to ten percent of the amount realized by the employee organization on the disposition or distribution.

Under the Act, no penalty tax will be applied to distributions or sales of employer securities made by reason of the death, the retirement after attainment of age 59½, the disability of the employee or the separation of an employee from service for any period resulting in a 1 year break in service. Similarly, it was intended that sales of employer securities to the employer to provide liquidity to make distributions by reason of the death, disability, retirement after age 59½, or the separation of an employee from service for any period resulting in a 1 year break in service would not be subject to the penalty tax.

In addition, although the term disposition generally includes any sale, exchange, or distribution, any exchange of qualified securities for securities of another corporation in a reorganization described in section 368(a)(1) will not be treated as a disposition for purposes of the excise tax.

Exclusive benefit

Under the Act, nonrecognition treatment is not available if assets attributable to the qualified securities involved in the nonrecognition transaction accrue directly or indirectly for the benefit of (1) the taxpayer involved in the nonrecognition transaction, (2) any member of the taxpayer's family (within the meaning of sec. 267(c)(4)), or (3) any other person who owns (after application of the sec. 318 attribution rules), more than 25 percent in value in any class of any outstanding employer securities. The Congress intended that the qualified status of any ESOP acquiring securities in a nonrecognition transaction be tested by separately applying the qualification rules to allocations of qualified securities and all other allocations. Thus, an ESOP is not to be considered to fail any of the requirements for tax qualification merely because it allocates the qualified securities in a manner designed to comply with this prohibition on allocations for the benefit of certain individuals. However, allocation of other assets in lieu of those attributable to

[103] Sec. 4978.

qualified securities, while not violating this prohibition, may otherwise cause prohibited discrimination because the allocation of other assets is tested separately.

Election and notice requirement

The taxpayer seeking nonrecognition treatment is required to file with the Secretary of the Treasury (1) a written election to claim nonrecognition treatment; (2) a verified written statement from the employer whose employees participate in the ESOP or an authorized officer of the worker-owned cooperative; and (3) information regarding the qualified replacement property.

To elect nonrecognition treatment under the Act, the seller must file a written election, as prescribed by the Secretary of the Treasury, not later than the due date of the seller's income tax return for the seller's taxable year in which the sale occurs.

In addition, nonrecognition treatment is not available unless the seller files with the Secretary a verified written statement of the employer or an authorized officer of the corporation consenting to the application of the section 4978 excise tax.

Finally, the seller is required to provide notice to the Secretary of (1) the seller's cost of acquiring replacement property (and an identification of such property), (2) the seller's intention not to acquire replacement securities within the replacement period, or (3) the seller's failure to acquire replacement securities within the replacement period. The form and manner of such notice is to be prescribed by the Secretary.

Failure to file an election to claim nonrecognition treatment or failure to file the required verified statement regarding the excise taxes disqualifies the seller from eligibility for the nonrecognition provision. Thus, gain is to be recognized on the sale of the qualified securities to the ESOP or cooperative. The applicable period of limitations with respect to a section 1042 nonrecognition transaction (generally three years) does not begin until the statement regarding replacement property is filed with the Secretary of the Treasury. Thus, failure to file notice regarding replacement property extends the usual period of limitations with respect to the transaction.

Effective date

The provision applies with respect to sales of securities in taxable years of the seller beginning after July 18, 1984.

2. Deduction for dividends paid on ESOP stock

Under the Act, an employer is entitled to deduct the amount of any dividends paid in cash during the employer's taxable year with respect to stock of the employer that is (1) held by an ESOP (including a tax credit ESOP) but only to the extent such dividends are actually paid out currently to participants or beneficiaries.[104]

The deduction is permitted for the employer's taxable year when paid to the extent such dividends (1) are, in accordance with the plan provisions, paid directly in cash to the participants or (2) are

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[104] Sec. 404(k).

paid to the plan and subsequently distributed to the participants in cash no later than 90 days after the close of the plan year in which paid. It is payment, not mere declaration of the dividends, which controls the timing of the deduction. Thus, if an employer's taxable year is the calendar year and if the employer declares a cash dividend on December 31, 1985, and pays the dividend during 1986, the employer is not entitled to the deduction with respect to the dividend until 1986. Moreover, to be deductible for a taxable year, dividends must be paid before the close of the year. Thus, the provisions of section 404(a)(6), which permit certain contributions to be deducted even though they are made after the close of the taxable year, do not apply. Because it is payment rather than declaration which controls the timing of the deduction, dividends declared prior to the effective date but actually paid after the effective date in compliance with this provision may be deducted.

A deduction is permitted under this provision only if the dividends are actually paid to participants. Thus, for example, an ESOP which permits a participant to elect not to receive current distribution of the dividends will not be permitted a deduction with respect to any dividends retained in the ESOP.

For income tax purposes, dividends distributed under an ESOP, whether paid directly to participants pursuant to plan provisions or whether paid to the plan and redistributed to participants, generally are treated as plan distributions. In addition, such dividends do not qualify for the partial exclusion from income otherwise permitted under Code section 116.

The Act provides that distributions of such dividends are not subject to the pension withholding rules.[105] Although no similar exception is provided with respect to the back-up withholding rules,[106] such rules do not apply because such dividends are treated as plan distributions.

This provision does not override the plan qualification rules relating to the timing of plan distributions and does not authorize an acceleration of such distributions. Accordingly, only to the extent that an ESOP is permitted to distribute dividends currently and does, in fact, make such distributions, will the dividends be deductible.

Similarly, this provision has no impact on the rules governing overall limits on contributions and benefits.[107] Thus, dividends payable with respect to qualified securities held by the ESOP are income which, as under prior law, does not constitute an annual addition under the plan.

As under prior law an employer who maintains a tax credit ESOP is entitled to deduct, within limits, amounts of administrative expenses.[108] The amount deductible is limited to the lesser of (1) the sum of (a) up to 10 percent of the first $100,000 of the ESOP's dividend income paid on employer securities, plus (b) five percent of the remaining dividend income, or (2) $100,000. Dividends deductible under this provision do not lose their character as

[105] Sec. 3405.
[106] Sec. 3406.
[107] Sec. 415.
[108] Sec. 409(i).

dividends paid to the plan for purposes of this limitation merely because they are currently distributed, directly or indirectly, to participants.

Effective date

The provision applies with respect to dividends paid in employer taxable years beginning after July 18, 1984.

3. Partial exclusion of interest earned on ESOP loans

Under the Act, a bank (within the meaning of sec. 581), an insurance company, or a corporation actively engaged in the business of lending money may exclude from gross income 50 percent of the interest received with respect to a securities acquisition loan.[109]

A securities acquisition loan means any loan to a corporation or to an ESOP to the extent that the proceeds are used to acquire employer securities (within the meaning of section 409(l)) for the plan. Thus, a loan made to an employer maintaining an ESOP may qualify for the exclusion to the extent that the proceeds are, in turn, loaned to the employer's ESOP on substantially similar repayment terms and used by the ESOP to acquire employer securities. However, (1) any loan made between corporations which are members of the same controlled group of corporations, and (2) any other loan made between an ESOP and the employer whose employees are covered by the plan (or a member of a controlled group which includes such employer) is not a securities acquisition loan eligible for this interest exclusion.

Congress did not intend that section 265 (regarding expenses and interest relating to tax-exempt income) should apply to transactions eligible for the exclusion provided by this provision. Similarly, Congress did not intend that section 291(e) (relating to certain tax preference items) should apply to income eligible for the exclusion provided by this provision.[110]

Effective date

The provision applies to loans made after July 18, 1984, used to acquire employer securities after such date. The provision does not apply to loans which are outstanding on July 18, 1984 (date of enactment) and directly or indirectly renegotiated after that date.

4. Payment of estate tax liability by ESOP

In general

If qualified employer securities (1) are acquired from a decedent by an ESOP or an eligible worker-owned cooperative, (2) pass from a decedent to an ESOP or worker-owned cooperative, or (3) are transferred by the decedent's executor to an ESOP or worker-owned cooperative, the Act generally relieves the executor of the decedent's estate of the the estate tax liability to the extent the ESOP or cooperative is required to pay the liability.[111]

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[109] Sec. 133.
[110] A technical correction may be necessary so that the statute reflects this intent.
[111] Sec. 2210.

Under the Act, the ESOP or worker-owned cooperative which receives the qualified securities for which an agreement is in effect is liable for a portion of the estate taxes otherwise imposed upon the decedent's taxable estate equal to the lesser of (1) the value (for Federal estate tax purposes) of the qualified employer securities received from the decedent or his or her executor, or (2) the estate tax imposed with respect to the taxable estate, reduced by the sum of allowable credits against such estate tax.

No executor is relieved of estate tax liability under this provision with respect to securities transferred to an ESOP unless the employer whose employees participate in the ESOP guarantees, by surety bond or other means as required by the Secretary of the Treasury, the payment of any estate tax or interest. This guarantee is in addition to any liens, etc., otherwise imposed by the Code with respect to amounts received from a decedent.

To the extent that (1) the decedent's estate is otherwise eligible to make deferred payments of estate taxes pursuant to section 6166 with respect to the decedent's interest in qualified employer securities, and (2) the executor elects to make payments pursuant to that section, then the plan administrator of the ESOP or an authorized officer of the worker-owned cooperative may also elect to pay any estate taxes attributable to the qualified employer securities transferred to the ESOP or cooperative in installments pursuant to that section.

As under prior law, this election would permit the payment of the estate taxes in installments for up to 14 years (annual interest payments for four years, followed by up to ten annual installments of principal and interest). Also, as under prior law, the special 4-percent interest rate would apply to estate taxes on the first $1 million of value of an interest in a closely held business. For purposes of computing the portion to which the special 4-percent interest rate applies, the portion of the estate tax for which the decedent's executor remains liable is aggregated with that portion for which the ESOP or cooperative is liable. Such portion is then allocated proportionately between the portion for which the executor remains liable and the portion for which the ESOP or cooperative is liable.

In addition, the remaining provisions of current law would apply to determine both initial and ongoing eligibility for deferred payment under section 6166. Thus, for example, payments of any unpaid tax would be accelerated in the event of delinquent payments, certain dispositions, or certain other events.

Elections, notices, etc.

The executor of the estate for which the ESOP or cooperative agrees to assume the estate tax liability attributable to qualified employer securities must elect the application of this provision (in the manner prescribed by Treasury regulations) no later than the time prescribed for filing the estate tax return. Such election must include a statement of the portion of the estate tax to be paid by the plan administrator or cooperative and such other information required by the Secretary of the Treasury. In addition, the Secretary is authorized to issue regulations requiring any statements, information returns, etc., necessary to assure compliance with this section. Pursuant to the Act, such election is invalid unless the executor obtains a written statement signed by the plan administrator or authorized officer of the worker-owned cooperative agreeing to imposition of the applicable estate tax liability and a written statement by the employer whose employees are covered by the ESOP agreeing to guarantee the payment of the liability.

The actual estate tax return filed by the executor of the decedent's estate must be made only with respect to that portion of the estate tax for which the executor is liable. The plan administrator of the ESOP or the worker cooperative receiving employer securities from the decedent's estate is required to file an estate tax return with respect to that portion of the estate tax which such ESOP or cooperative is required to pay.[112]

Prohibited transactions

If an ESOP assumes the estate tax liability with respect to employer securities received from the decedent's estate, the liability assumed by the ESOP will be treated as a loan as described in section 4975(d)(3).

Effective date

The provision applies with respect to those estates of decedents that are required to file returns on a date (including extensions) after July 18, 1984.

Revenue Effect

The revenue effects of these provisions are included in the revenue effect for section 14 of the Act (see title I.A. 4., above).

[112] Sec. 6018.

E. Miscellaneous Benefit Provisions

1. Treatment of Certain Distributions from a Qualified Terminated Plan (sec. 551 of the Act)[113]

Prior Law

If a lump sum distribution is paid to an employee (or to the spouse of a deceased employee) under a qualified plan, tax is deferred on the portion of the distribution rolled over, within 60 days, to another qualified plan or to an IRA. A distribution from a qualified plan is not a lump sum distribution unless it consists of the balance to the credit of the employee under the plan and is made within one taxable year of the recipient.

Reasons for Change

The Congress believed that prior law unfairly denied rollover treatment to a taxpayer who received payments from a qualified plan in December, 1976 and January, 1977. The Congress believed that such a distribution should be accorded tax-free rollover treatment.

Explanation of Provision

The Act provides special relief for certain qualified plan distributions received during 1976 and 1977 and transferred to an IRA. Under the Act, the transfers are treated as a qualifying rollover distribution. Thus, to the extent the payments were, in fact, rolled over to an IRA within 60 days after receipt, the distribution will not be includible in income.

In addition, the Act provides an extension of the usual period of limitation for filing a claim for credit or refund of taxes paid (generally, three years after the later of (1) the date prescribed for filing the tax return, or (2) the date the return was actually filed). Under the Act, the statutory period of limitation is extended to permit the filing of a claim for credit or refund attributable to changes made by the Act within one year after July 18, 1984.

Effective Date

The provision became effective on July 18, 1984.

Revenue Effect

The provision will have a negligible effect on budget receipts.

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[113] For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 112; S. Prt. 98-169, Vol. I (April 2, 1984), p. 339; and H. Rep. No. 98-861 (June 23, 1984), p. 1148 (Conference Report).

2. Special Rule for Trans-Alaskan Pipeline Employees (sec. 552 of the Act)[114]

Prior Law

In general

Under a qualified plan, benefits are provided to participants under plan formulas that determine the amount of the benefit a participant may earn, the portion of that benefit that has been earned (accrued), and the portion of the earned benefit that is nonforfeitable (vested).

The rules of the Employee Retirement Income Security Act of 1974 (ERISA) and of the Code generally require that a qualified plan meet one of three alternative minimum vesting schedules. Under these schedules, an employee's right to benefits derived from employer contributions vests to varying degrees upon completion of specified periods of service with an employer.

Under one of the minimum schedules, full vesting is required upon completion of 10 years of service (no vesting is required before the end of the 10th year). Under a second schedule, vesting begins at 25 percent after completion of five years of service and increases gradually to 100 percent after completion of 15 years of service.

Partial terminations

Under the Code, in the event of the partial termination of a qualified plan, the rights of all affected employees to benefits accrued to the date of the partial termination generally must be nonforfeitable to the extent those benefits are funded.

Whether a partial termination of a qualified plan has occurred (and the time of its occurrence) is determined by the Commissioner of Internal Revenue on the basis of all the facts and circumstances in a particular case. According to Treasury Regulations, the facts and circumstances include (1) the exclusion, by reason of a plan amendment or severance by the employer, of a group of employees who previously have been covered by the plan; and (2) plan amendments that adversely affect the rights of employees to vest in benefits under the plan. The partial termination rule is designed to protect against forfeiture the benefits earned by employees and funded by an employer.

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[114] For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 113; S. Prt. 98-169, Vol. I (April 2, 1984), p. 340-41; and H. Rep. No. 98-861 (June 23, 1984), p. 1148-49 (Conference Report).

Reasons for Change

The Congress believed that, in the unusual case of the Trans-Alaska Oil Pipeline construction project, the partial termination rules should not apply.

Explanation of Provision

Under the Act, in applying the rules of the Code relating to partial terminations, a partial termination will not be treated as occurring if requirements are satisfied as to the occurrence of the partial termination, discrimination in favor of certain employees, and reversions.

The Act applies to a partial termination only if it occurs by reason of the completion of the Trans-Alaska Oil Pipeline construction project. Further, the Act is limited to a partial termination occurring after December 31, 1975, and before January 1, 1980, with respect to participants employed in Alaska. The relief from the usual rules for partial terminations does not apply if the partial termination causes contributions or benefits under the plan to discriminate in favor of employees who are officers, shareholders, or highly compensated.

The provision does not apply unless the plan administrator establishes to the satisfaction of the Secretary of the Treasury that the benefits of the provision will not accrue to any employers under the plan. Thus, the provisions of the Act do not apply to a plan unless the plan precludes any reversion of plan assets to an employer who maintains the plan as the result of the exclusion of any other employer from further participation in the plan.

Effective Date

The provision became effective on July 18, 1984.

Revenue Effect

The provision will have a negligible effect on budget receipts.

3. Distribution Requirements for Plans, Accounts, and Annuities of an Insurer in Rehabilitation Proceedings (sec. 553 of the Act)[115]

Prior Law

Distributions under a qualified plan generally are required to commence no later than April 1 of the year following the later of the taxable year in which a participant (1) retires or (2) attains age 70 1/2. Distributions under an individual retirement account or annuity (IRA) are required to commence no later than the year in which the owner attains age 70 1/2. If the IRA distribution rules are not satisfied, a 50-percent excise tax is applied to the undistributed portion of the amount that should have been distributed.

Reasons for Change

The Congress was aware that the owners of certain IRAs are facing potential excise taxes because the insurer holding the IRAs is engaged in rehabilitation proceedings. In addition, some qualified plans may be disqualified because the insurer may not make payments to plan participants during the period in which the insurer is engaged in rehabilitation proceedings. The Congress believed it was inappropriate to impose the sanctions for failure to make a required withdrawal or distribution under these circumstances.

Explanation of Provision

The Act provides that an amount is not required to be distributed under the usual rules for qualified plans and IRAs to the extent that the amounts are held by an insurer that, on March 15, 1984, is engaged in a rehabilitation proceeding under applicable State insurance law (e.g., Baldwin-United Corp.). The provision applies only for the period during which the insurer is engaged in the proceedings.

If an individual is given an election to receive a benefit currently that is less than the individual's accrued benefit or account balance, then, solely for purposes of this provision, the amount actually distributed to the individual is treated as the amount required to be distributed. Thus, if an individual receives a reduced amount currently, the individual would not be subject to a sanction for failure to receive the minimum required distribution.

Effective Date

The provision became effective upon July 18, 1984.

[115] For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 114; S. Prt. 98-169, Vol. I (April 2, 1984), p. 342; and H. Rep. No. 98-861 (June 23, 1984), p. 1149 (Conference Report).

Revenue Effect

The provision will have a negligible effect on budget receipts.

4. Extension of Time for Repayment of Qualified Refunding Loans (sec. 554 of the Act and sec. 236(c)(2) of TEFRA)[116]

Prior Law

TEFRA imposed limits on the extent to which an individual can borrow amounts from a qualified plan without the loan being treated as a distribution to the individual under the plan. Under TEFRA, a transition rule was provided for certain "qualified refunding loans" made on or after August 13, 1982, and repaid before August 14, 1983.

Reasons for Change

The Congress was concerned that some individuals may not have been able to secure alternate financing in order to repay a qualified refunding loan by August 14, 1983. Therefore, the Congress believed it was appropriate to extend the repayment period on such loans for individuals for whom it may have been more difficult to secure alternate financing.

Explanation of Provision

The Act extends the period for making and repaying a qualified refunding loan to January 1, 1985, with respect to individuals who are not key employees (within the meaning of sec. 416(i), determined without regard to whether the plan is top heavy).

Effective Date

The provision became effective as if enacted in TEFRA.

Revenue Effect

The provision will have a negligible effect on budget receipts.

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[116] For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 115; S. Prt. 98-169, Vol. I (April 2, 1984), p. 343; and H. Rep. No. 98-861 (June 23, 1984), p. 1149-50 (Conference Report).

5. Incentive Stock Options (sec. 555 of the Act and secs. 57 and 422A of the Code)[117]

Prior Law

Under prior and present law, the tax treatment of employee stock options generally is governed by section 83 and the regulations thereunder (Treas. Reg. sec. 1.83-7). Under these rules, the value of a stock option constitutes ordinary income to the employee when granted only if the option itself has a readily ascertainable fair market value at that time.[118] If the option does not have a readily ascertainable value when granted, it does not constitute ordinary income at that time. Instead, when the option is exercised, the difference between the value of the stock at exercise and the option price constitutes ordinary income to the employee. For this purpose, the value of the stock is determined without regard to restrictions other than restrictions which by their terms will never lapse.

An employer who grants a stock option generally is allowed a business expense deduction equal to the amount includible in the employee's income in its corresponding taxable year (sec. 83(h)).

In addition, prior and present law provides for "incentive stock options", under which there is no tax consequences when the option is granted or, except for the alternative minimum tax, when the option is exercised, and the employee generally is taxed at capital gains rates when the stock received on exercise of the option is sold. No business expense deduction is allowed to the employer with respect to an incentive stock option (sec. 421(a)).

Prior law provided that the option price of an incentive stock option must have equalled or exceeded the fair market value of the stock at the time the option was granted. These options must not have been exercisable while an earlier incentive stock option was outstanding. This rule prevented a downward adjustment in the option price by the granting of a new option where the stock had declined in value.

In addition, these options could not be transferable by the employee other than by reason of death. A special rule provided that the change in terms of an option to meet the nontransferability requirements would not be treated as the grant of a new option requiring the option price to be set by reference to the stock's fair market value on the modification date (sec. 425(h)(3)(B)).

[117] For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 827; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 765-768; Senate floor amendment, 130 Cong. Rec. S. 4295 (April 11, 1984); and H. Rep. No. 98-861 (June 23, 1984), p. 1178 (Conference Report).

[118] Section 83 does not apply to the transfer of an option without a readily ascertainable fair market value (sec. 83(e)(3)). Treas. Reg. sec. 1.83-7(a) implies that no income is realized upon grant of such an option.

Finally, the difference between the fair market value of the stock on the date the option was exercised and the option price of the stock was an item of tax preference for purposes of the individual alternative minimum tax.

Reasons for Change

The incentive stock provisions were adopted to provide capital gain treatment to employees by reason of increases in the value of certain stock of the employer corporation. Congress did not wish to give this capital gain treatment to increases in value caused simply by reason of the lapse of restrictions with respect to the stock. Therefore, the Act clarifies that the fair market value of the stock is to be determined without regard to these restrictions. This is consistent with the valuation rules with respect to stock issued to employees under section 83, and will result in the minimum tax preference being equal to the amount that would have been includible in income if the incentive stock option provisions had not been applicable.

Explanation of Provision

The incentive stock option provisions are amended to insure that the principles of the fair market value requirements may not be avoided. The determination of fair market value is to be made without regard to any restriction other than a restriction which, by its terms, will never lapse. This applies both for the incentive stock option qualification requirements and the determination of the minimum tax preference.

Also, a change in the terms of an option to make it nontransferable in order to qualify as an incentive stock option will be treated as the grant of a new option. The option will thus be required to meet the incentive stock option requirements, including the option price requirement, based on the later grant date.

Effective Date

The amendment to section 422A(c)(10) applies to options granted after March 20, 1984, other than options granted before September 20, 1984, pursuant to action taken by the board of directors of the grantor corporation before May 15, 1984.

The amendment to section 57(a)(10) applies to options exercised after March 20, 1984. In the case of an option issued after March 20, 1984, pursuant to a plan adopted or corporate action taken by the board of directors of the grantor corporation before May 15, 1984, the amendment will not apply if the option is exercised on or before December 31, 1984.

The amendment to section 425(h) applies to modifications of options after March 20, 1984.[119]

Revenue Effect

This provision will have a negligible effect on receipts.

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[119] The subsection references in the effective date provisions (Act sec. 555(c)) are incorrect. It is anticipated that a technical correction will be made.

6. Certain Section 83(b) Elections (sec. 556 of the Act and sec. 83 of the Code)[120]

Prior Law

Property transferred to an employee in connection with the performance of services was includible in income (to the extent the value of the property exceeded the amount paid) in the first taxable year the property was transferable and not subject to a substantial risk of forfeiture (sec. 83). A taxpayer could elect, within 30 days of the transfer of property, to include in gross income the excess of the value of the property (determined without regard to restrictions) over the amount paid, for the year the transfer occurs (sec. 83(b)). A recent Tax Court decision held that section 83 may apply where the employee paid fair market value for the property (determined without regard to restrictions). *Alves* v. *Commissioner*, 79 T.C. 864 (1982), aff'd No. 83–7491 (9th Cir., June 5, 1984).

Reasons for Change

The Congress was concerned that the decision in the *Alves* case may have caused investors in start-up companies to lose capital gains treatment because of their failure to have made timely section 83(b) elections. Therefore, in order to prevent this from occurring, the time period to make an election was extended in situations where the transfer was made prior to the date of decision in the *Alves* case.

Explanation of Provision

The Act allows a taxpayer to make the election under section 83(b) with the first tax return filed after July 18, 1984, with respect to transfers of property made after June 30, 1976 and before November 18, 1982 (the date of decision of the *Alves* case), if the taxpayer paid fair market value for the property (determined without regard to restrictions), and the employer consents to the election.

Effective Date

The provision applies to transfers after June 30, 1976, and before November 18, 1982.

Revenue Effect

The provision will have a negligible effect on budget receipts.

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[120] For legislative background of the provision, see: Senate floor amendment, 130 Cong. Rec. S. 4509 (April 12, 1984); and H. Rep. No. 98-861 (June 23, 1984), pp. 1178-1179 (Conference Report).

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7. Employer and Welfare Benefit Fund Treated as Related Persons (sec. 557 of the Act and sec. 1239 of the Code)[121]

Prior Law

The gain from the sale of depreciable property between certain related taxpayers is treated as ordinary income. Under prior law, an employer and a welfare benefit fund controlled by the employer generally were not treated as related parties.

Reasons for Change

The Congress was concerned that employers may be encouraged by prior law to assign inappropriate values to property contributed to an employer-controlled fund under a funded welfare benefit plan. Accordingly, the Congress believed that it is appropriate to treat such a transaction as a transaction between related parties and, thus, any gain realized by the employer would be treated as ordinary income instead of capital gain.

Explanation of Provision

Under the Act, welfare benefit funds are treated as related parties with respect to an employer under the rules of the Code treating gain on certain transactions as ordinary income. The Act provides that an employer (and any person related to the employer) is considered to be related to a welfare benefit fund that is controlled, directly or indirectly, by the employer, by a person related to the employer, or by the employer and a person related to the employer.

Effective Date

The provision applies to sales or exchanges after July 18, 1984, in taxable years ending after that date.

Revenue Effect

The provision will have a negligible effect on budget receipts.

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[121] For legislative background of the provision, see: committee amendment to H.R. 4170, approved by the House Committee on Ways and Means on March 1, 1984, sec. 115; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), p. 1293; "Deficit Reduction Act of 1984", as approved by the Senate Committee on Finance on March 24, 1984, sec. 99; S. Prt. 98-169, Vol. I (April 2, 1984), p. 328; and H. Rep. No. 98-861 (June 23, 1984), p. 1165 (Conference Report).

8. Elimination of Retroactive Application of Amendments Made by Multiemployer Pension Plan Amendments Act of 1980 (Sec. 558 of the Act)[122]

Prior Law

The Multiemployer Pension Plan Amendments Act of 1980 (MPPAA) was enacted on September 26, 1980. Under the Employee Retirement Income Security Act of 1974 (ERISA), as amended by the MPPAA, liability generally was imposed on an employer who withdrew from a multiemployer defined benefit pension plan. The withdrawal liability provisions of the MPPAA generally applied retroactively to withdrawals after April 28, 1980.

Reasons for Change

Many employers who withdrew from multiemployer plans prior to the date of enactment of the MPPAA may have unexpectedly incurred significant retroactive withdrawal liability. The Congress believed that the collection of withdrawal liability payments with respect to the withdrawals that took place during the retroactive period are not necessary to protect the financial integrity of multiemployer defined benefit pension plans.

Explanation of Provision

Generally, under the Act, any liability incurred by an employer under the withdrawal liability provisions of ERISA, as a result of the complete or partial withdrawal from a multiemployer plan before September 26, 1980, is void.

Under the Act, a plan sponsor is required to refund with interest any amounts paid by an employer to a plan sponsor as a result of any withdrawal liability imposed by reason of a complete or partial withdrawal from a multiemployer plan before September 26, 1980. The interest rate is to be the rate that would apply if the withdrawal liability payment were a contribution paid by reason of a mistake and if section 401(a)(2) of the Code applied to the return of the contribution. The amount refunded may be reduced by a reasonable amount for administrative expenses incurred by the plan sponsor, other than legal expenses of the plan, in collecting the liability.

In the case of an employer who, on September 26, 1980, had a binding agreement to withdraw from a multiemployer plan, the effective date for withdrawal liability is changed to December 31, 1980.

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[122] For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 111; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 337-38; and H. Rep. No. 98-861 (June 23, 1984), pp. 1147-48 (Conference Report).

Effective Date

The provision became effective on July 18, 1984.

Revenue Effect

The provision will have a negligible effect on budget receipts.

9. Pension Portability Involving Telecommunications Divestiture (sec. 559 of the Act)[123]

Prior Law

In general

Under a qualified plan, benefits are provided to participants under plan formulas that determine the amount of the benefit a participant may earn, the portion of that benefit that has been accrued, and the portion of the earned benefit that is nonforfeitable (vested). Accordingly, plans provide rules for determining whether an employee is a plan participant (the employee participation rules), for measuring benefits (the benefit formula), for determining the portion of the benefit that has been accrued (the benefit accrual rules), and for determining the vested percentage of a participant's benefit (the vesting schedule).

A qualified plan must satisfy certain minimum standards relating to the conditions under which employees may be excluded from plan participation, to the method under which plan benefits are accrued, and to the vesting schedule. The participation standards limit the permissible exclusions based on the age and period of service completed by an employee. The benefit accrual standards are based upon the number of years of plan participation. The vesting schedule standards generally are based upon the number of years of service with the employer that the employee has completed.

In general, all years of service with the employer maintaining the plan must be taken into account for purposes of the minimum participation requirements. Years of service during any period for which the employer did not maintain the plan or a predecessor plan need not be taken into account in determining years of service for vesting purposes. In any case in which an employer maintains a plan of a predecessor employer, service for the predecessor is treated as service for the employer.

Two or more employers generally may agree to provide for transferability of benefit and service credits (portability) under their plans even though they were never related and one employer is not a predecessor of the other employer.

Limits on contributions and benefits

Under present and prior law, limits are imposed on contributions and benefits under qualified plans. The limits are based, in part, on the number of years of an employee's service with the employer

[123] For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 116; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 344-346; and H. Rep. No. 98-861 (June 23, 1984),pp. 1150-54 (Conference Report).

and on the employee's compensation from the employer. In addition, present and prior law provide for the aggregation of contributions and benefits under plans maintained by separate employers for purposes of the overall limits on contributions and benefits in situations in which prior service with another employer is recognized by the employer.

Court order

Pursuant to a court order in the case of *United States v. Western Electric, et alia,*[124] relating to the divestiture of its former subsidiaries, the assets and liabilities of the pension plan of the American Telephone and Telegraph Company (AT&T) are to be allocated between AT&T and its former subsidiaries. Under the modified final judgment, an employee's service performed before 1985 was treated as service for each other employer subject to the judgment. Under the judgment, however, post-1984 service for one of the employers subject to the judgment was not to be taken into account as service by any of the other employers subject to the judgment.

Prior to divestiture, the Bell System Pension Plan provided for the full recognition and interchange of service credit and benefit obligations between and among all participating Bell System companies, Cincinnati Bell, and Southern New England Telephone. These provisions were formally known as "interchange" agreements.

After divestiture, the interchange agreements were no longer applicable. In place of those agreements, a "divestiture interchange agreement" was entered into by AT&T, the regional Bell operating companies, the BOCs' Central Services Organization, Advanced Mobile Phone Service, Inc., and Cincinnati Bell.

The divestiture interchange agreement provides continued mutual reciprocal recognition of post-divestiture service credit between and among AT&T, the divested Bell operating companies, and the other parties to that agreement. Recognition of service credit applies for all purposes, including seniority provisions under applicable collective bargaining agreements.

The applicability of the divestiture interchange agreement is limited to calendar year 1984, in the case of most Bell System employees. Under the agreement, therefore, most AT&T and Bell company employees would not be able to take their accumulated service credit with them in the event of a move after 1984 from one local Bell company to another, or between a local Bell company and AT&T.[125] The Plan of Reorganization, including this limited portability of service credit, was approved by U.S. District Judge Harold H. Greene on August 5, 1983.[126]

Reasons for Change

The Congress believed that, under the circumstances, employees who are transferred between AT&T and its former subsidiaries or

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[124] Civil Action No. 82-0192 (D.D.C. 1982).

[125] *See* Plan of Reorganization submitted on December 16, 1982, in *United States v. Western Electric Co., et al,* Civil Action No. 82-0192 (D.D.C. 1982), 284-289.

[126] *United States v. Western Electric Co., et al,* 569 F. Supp. 1057, 1091-1097 (D.D.C. 1983), *aff'd sub nom., California v. United States,* 52 U.S.L.W. 3460 (December 12, 1983).

between former subsidiaries as a result of the divestiture should be credited by the formerly affiliated companies with post-divestiture service.

Explanation of Provision

Under the Act, in the case of any change in employment on or after January 1, 1985, by a covered employee, the recognition of service credit and the enforcement of such recognition, shall be governed in the same manner and to the same extent as provided under the divestiture interchange agreement for a change in employment by a covered employee during calendar year 1984.

Notwithstanding the time limitations in the divestiture interchange agreement, the Act permanently extends, beyond 1984, the provisions of the agreement that govern the recognition of service credit and the enforcement of such recognition, in the case of any change in employment by a covered employee on or after January 1, 1985. For such an employee, there would be no time limitation on the portability of service credit granted under the divestiture interchange agreement. In addition, employees of Southern New England Telephone Company are also covered by the legislation, even though the company did not sign the divestiture interchange agreement.

Under the Act, a covered employee is an employee of an entity subject to the modified final judgment who is serving in an eligible position, and who was either (A) an employee of an entity subject to the modified final judgment and serving in an eligible position on December 31, 1983, or (B) a former employee who had rehire or recall rights on December 31, 1983, under applicable collective bargaining agreements and who is rehired during the period of his or her rehire or recall rights. A covered employee can move from one entity subject to the modified final judgment to another such entity without losing service credit.

A person need not work continuously after December 31, 1983, for an entity subject to the modified final judgment (a "subject entity"), in order to be considered a covered employee. For example, an employee who was working for a subject entity on December 31, 1983, might continue to work for that company during 1984 and 1985, but leave in 1986 for a job with a firm that is not a subject entity. In 1987, the employee might return to work at a subject entity (although not necessarily the same company the employee left in 1986). Under those circumstances, the employee would be a covered employee during 1984 and 1985, and again beginning in 1987. The subject entity for which the employee is working in 1987 must recognize the service credit the employee accumulated during employment with other subject entities. Subject entities need not recognize service credit earned at firms that are not subject to the modified final judgment; nor does the provision require employers who are not subject to the modified final judgment to recognize service credit earned at subject entities.

The Act provides that "service credit" means service credit for benefit accrual, vesting, and eligibility for any benefits under a pension plan or any other employee benefits, including seniority rights; the right to other benefits such as medical and dental care, insurance, and disability payments; the ability to bid on vacations and shifts; and any other rights that have been secured under applicable collective bargaining agreements. The term also includes the interchange and treatment of associated benefit obligations and assets.

"Change in employment" means the movement of a covered employee from one entity subject to the modified final judgment to another such entity. Even if there is a break in service—for instance, where a person moves from one entity subject to the modified final judgment to a firm not subject to the judgment, and from there to another entity that is subject to the agreement—the eventual movement from the first entity subject to the modified final judgment to the second such entity is a "change in employment" for purposes of this legislation. However, only service credit earned at entities subject to the modified final judgment is required to be recognized in the event of a change in employment.

Under the Act, an "eligible position" means a nonsupervisory position, or a position that pays not more than $50,000 (adjusted by the percentage increase in the consumer price index since December 31, 1983). "Modified final judgment" means the settlement antitrust suit, *United States v. Western Electric Co., et al.*, Civil Action No. 82-0192 (D.D.C.).

"Entity subject to the modified final judgment" means the 22 Bell operating companies divested under the settlement (except for any subsidiary that does not participate in a defined benefit pension plan, as discussed below); Southern New England Telephone Company and Cincinnati Bell, Inc., which were not divested under the antitrust settlement, but in which AT&T held a minority interest on December 31, 1983; and any Interchange Company, as defined in the divestiture interchange agreement, together with any subsidiary of such company that was established as of December 31, 1983, and that participates in a defined benefit pension plan maintained by the Interchange Company.

AT&T, the seven regional Bell holding companies, the BOC's Central Services Organization (now called Bell Communications Research, Inc.), Advanced Mobile Phone Service, Inc., and Cincinnati Bell, Inc. are Interchange Companies under the divestiture interchange agreement and, therefore, are included in the term "entity subject to the modified final judgment." In addition, all Interchange Company subsidiaries established as of December 31, 1983 (except for AT&T's Sandia Corporation, U.S. West's Beta West, Inc., U.S. West Services, Inc., and Bell South Enterprises), currently participate, or shortly plan to participate, in a defined benefit pension plan. Consequently, they are also entities subject to the modified final judgment. These subsidiaries include, but are not limited to Bell Labs, Western Electric, AT&T Information Systems, and the cellular radio subsidiaries of the regional Bell operating companies. Nothing in the Act restricts the ability of any Interchange Company to extend portability of service credit to employees at any other subsidiary, under a collective bargaining agreement, for example, or by any other means.

Subsidiaries established as of December 31, 1983, did not participate in defined benefit pension plans until after that date. Any subsidiary that participates in such a plan, regardless of when the decision to participate is made, will be included in the term "entity subject to the modified final judgment. Such term also includes any subsidiary that participates in a defined benefit pension plan on the date of enactment of the Act.

Under the Act, "divestiture interchange agreement" means the agreement among the Bell system companies and AT&T, executed as of November 9, 1983, which provides for mutual reciprocal recognition of service credit. "Consumer price index" means the Consumer Price Index (all items—United States city average) published monthly by the Bureau of Labor Statistics.

The Congress did not intend the Act to limit benefits that are otherwise available to any individual under the provisions of the modified final judgment (including the divestiture interchange agreement), under applicable law, or otherwise. This includes, but is not limited to, rights under the Communications Act of 1934, as amended, and the Employee Retirement Income Security Act of 1974 (ERISA), as amended. A person alleging a violation of this legislation may seek redress under the Communications Act of 1934 (which governs communications common carriers), under applicable labor and pension statutes, or at common law.

The Act does not provide special rules with respect to the limits on contributions and benefits under section 415. The Act continues the rules of prior law that provide for the aggregation of contributions and benefits under plans maintained by separate employers for purposes of the overall limits on contributions and benefits in situations in which prior service with another employer is recognized by the employer.

Effective Date

The provision became effective on July 18, 1984.

Revenue Effect

The provision will have a negligible effect on budget receipts.

10. Limitation on Accrual of Vacation Pay (sec. 561 of the Act and sec. 463 of the Code)[127]

Prior Law

Under prior law, an employer using an accrual method of accounting could, instead of accounting for the accrual of vacation pay under general rules, elect under section 463 to deduct an amount representing a reasonable addition to a reserve account for contingent vacation pay earned by employees in the current year and payable by the close of that year or within 12 months thereafter. For electing employers, a deduction was allowed in the current year regardless of when the amount was actually paid, so long as the employees had a right to receive the payments during that year or the following year.

Reasons for Change

Congress understood that, for a taxable year, some employers were accruing and deducting vacation pay that becomes payable during the twelve months after the end of the taxable year, even though it was not reasonable to expect that all of the vacation pay would be paid during such period. Congress believed that the deductions allowed in advance of the actual payment of vacation pay under the special rules for this pay should be limited to the amount that the employer reasonably expects to pay during the twelve months after the end of the employer's taxable year.

Explanation of Provision

The Act amends the special rules for the deductions by accrual method taxpayers for vacation pay so that the deduction for a year equals a reasonable addition to the account representing the taxpayer's liability for vacation pay (contingent or vested) earned by employees before the close of the taxable year and expected to be paid during the taxable year or within 12 months following the close of the taxable year. For example, in the case of a taxpayer who makes this determination at the end of a taxable year, the reasonable addition for the year is the amount necessary so that the balance in the account at the beginning of the next taxable year is the amount reasonably expected to be paid in that year. Thus, if the balance in the account, before any addition, is greater than this amount, no additional deduction is allowed. The prior law rules that also allow a deduction for reductions in certain suspense accounts are retained.

[127] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec 117; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1296-1297; H. Con. Res. 328, 130 Cong. Rec. S. 8946 (June 29, 1984), H. 7527 (June 23, 1984).

Effective Date

The provision applies to taxable years beginning after March 31, 1984.

Revenue Effect

The revenue estimate for this provision is included in the revenue effect set forth under the welfare benefit plan provisions (see V. A. 7., above).

TITLE VI—TAX-EXEMPT BOND PROVISIONS[1]

A. Mortgage Subsidy Bonds and Mortgage Credit Certificates

(Secs. 611-614 of the Act, sec. 103A and new secs. 25 and 6709 of the Code, [2] and sec. 1104 of the Mortgage Subsidy Bond Tax Act of 1980)

Prior Law

Overview

The Mortgage Subsidy Bond Tax Act of 1980 (the "1980 Act")[3] imposed restrictions on the ability of State or local governments to issue bonds, the interest on which is tax-exempt, to finance mortgage loans on single-family, owner-occupied residences. The 1980 Act provided that interest on mortgage subsidy bonds would be exempt from taxation only if the bonds were "qualified veterans' mortgage bonds" or "qualified mortgage bonds".

The authority of State and local governments to issue tax-exempt qualified mortgage bonds under the 1980 Act expired on December 31, 1983.

Qualified veterans' mortgage bonds

Qualified veterans' mortgage bonds are general obligation bonds, the proceeds of which are used to finance mortgage loans to veterans. Under prior law, qualified veterans' mortgage bonds were not subject to most of the restrictions applicable to qualified mortgage bonds. Unlike qualified mortgage bonds, the tax-exemption for interest on qualified veterans' bonds did not expire on December 31, 1983.

Qualified mortgage bonds

Qualified mortgage bonds are required to satisfy the following requirements under prior law (and present law).

Volume limitations

The 1980 Act restricted the aggregate annual volume of qualified mortgage bonds that a State, and local governments within that

[1]For legislative background of the provision, see: H.R. 4710, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, secs. 701, 711-712, 721-726, and 731; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), p. 1664; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, secs. 701-704 and 711-721; S. Prt. 98-169, Vol. I (April 2, 1984), p. 674; Senate floor amendments, 130 Cong. Rec. S. 4120, 4121, and 4122 (April 9, 1984), S. 4295, 4308, and 4337 (April 11, 1984), and S. 4433, 4462, 4513, 4517, and 4550 (April 12, 1984); H. Rep. No. 98-861 (June 23, 1984), p. 1185 (Conference Report); and H. Con. Res. 328, 130 Cong. Rec. S. 8946 and H. 7527 (June 29, 1984).

[2]This section of the Code was incorrectly numbered section 6708 in the Act.

[3]Title XI of the Omnibus Reconciliation Act of 1980 (P.L. 96-499). The provisions adopted by the 1980 Act (Code sec. 103A) were subsequently amended by section 220 of the Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248) (TEFRA).

State, are permitted to issue. Under that Act, the State volume limitation is equal to the greater of (1) nine percent of the average annual aggregate principal amount of mortgages executed during the three preceding years for single-family, owner-occupied residences located within the State, or (2) $200 million. The State volume limitation generally is allocated 50 percent to State and 50 percent to local issuers (on the basis of mortgage activity) unless the State enacts a statute providing for a different allocation.

As an interim rule, the 1980 Act authorized the governor of any State to allocate that State's volume limitation until the State legislature met in its first regular session after 1980.

Limitation to single-family, owner-occupied residences

All lendable proceeds (i.e., total proceeds less issuance costs and reasonably required reserves) of qualified mortgage bonds must be used to finance the purchase of single-family residences located within the jurisdiction of the issuing authority.[4] Additionally, it must reasonably be expected that each residence will become the principal residence of the mortgagor within a reasonable time after the financing is provided. The term single-family residence includes two-, three-, and four-family residences if (1) the units in the residence are first occupied at least five years before the mortgage is executed, and (2) one unit in the residence is occupied by the owner of the units.

General limitation to new mortgages

With certain exceptions, all lendable proceeds of qualified mortgage bonds must be used for acquisition of new mortgages rather than existing mortgages. The exceptions permit replacement of construction period loans and other temporary initial financing, and certain rehabilitation loans. Rehabilitation loans must be made for work begun at least 20 years after the residence is first used, and the rehabilitation expenditures are required to equal 25 percent or more of the mortgagor's adjusted basis in the building. Additionally, at least 75 percent of the existing external walls of the building must be retained as such after the rehabilitation.

Certain mortgage assumptions permitted

Assumptions of loans financed with qualified mortgage bond proceeds are permitted if the residence satisfies the location and principal residence requirements, discussed above, and the assuming mortgagor satisfies the three-year and purchase price requirements, discussed below.

Limitation on advance refunding

Advance refunding of qualified mortgage bonds is not permitted.

Targeting requirement

At least 20 percent of the lendable proceeds of each issue of qualified mortgage bonds (but not more than 40 percent of the av-

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[4]TEFRA included changes in the mortgage subsidy bond provisions designed to enable tenant shareholders of cooperative housing corporations (sec. 216) to qualify for tax-exempt financing as owners of single-family residences.

erage mortgage activity in the targeted area) must be made available for owner-financing in targeted areas for a period of at least one year. The term "targeted area" is defined as a census tract in which 70 percent or more of the resident families have income that is 80 percent or less of the Statewide median family income, or an area designated as an area of chronic economic distress.

Three-year requirement

In order for an issue to be a qualified mortgage bond issue, at least 90 percent of the lendable proceeds must be used to finance residences for mortgagors who have had no present ownership interest in a principal residence at any time during the three-year period ending on the date the mortgage is granted.[5] The three-year requirement does not apply with respect to mortgagors in three situations: (1) mortgagors of residences that are located in targeted areas; (2) mortgagors who receive qualified home improvement loans;[6] and (3) mortgagors who receive qualified rehabilitation loans.

Purchase price restrictions

For an issue to be a qualified mortgage bond issue, all of the mortgage loans (or other financing) provided from the bond proceeds, except qualified home improvement loans, must be for the purchase of residences the acquisition cost of which does not exceed 110 percent (120 percent in targeted areas) of the average area purchase price applicable to that residence.[7]

Arbitrage requirements

The 1980 Act imposed special arbitrage requirements on qualified mortgage bonds, in addition to the requirements imposed on tax-exempt bonds generally. A qualified mortgage bond issue is required to meet specified limitations regarding arbitrage as to both mortgage loans and nonmortgage investments.

Mortgage investments.—The effective rate of interest on mortgages provided with an issue of qualified mortgage bonds may not exceed the yield on the issue by more than 1.125 percentage points.[8] This determination is made on a composite basis for all mortgage loans made from the proceeds of the issue. Consequently, the effective interest rate on some mortgages is permitted to be greater than 1.125 percentage points above the yield of the issue if other mortgages have a lower effective interest rate.

Nonmortgage investments.—The amount of qualified mortgage bond proceeds that may be invested at unrestricted yield in nonmortgage investments is limited to 150 percent of the debt service on the issue for the year. Exceptions to the 150-percent of debt

[5]TEFRA reduced the percentage of bond proceeds that are required be used in a manner satisfying the three-year requirement from 100 percent to 90 percent, effective for bonds issued after September 3, 1982.

[6]Qualified home improvement loans are loans, not exceeding $15,000, to finance the alteration or repair of a residence in a manner that substantially protects "the basic livability or energy efficiency of the property" (sec. 103A(*l*)(6)).

[7]TEFRA increased the maximum purchase price restriction from 90 percent (110 percent in targeted areas) to the levels discussed above, effective for bonds issued after September 3, 1982.

[8]TEFRA increased the maximum permitted arbitrage from 1 percentage point to 1.125 percentage points, effective for bonds issued after September 3, 1982.

service rule are provided for proceeds invested for an initial temporary period until such proceeds are needed for mortgages and for temporary debt service funds. Arbitrage earned on nonmortgage investments must be paid or credited to the mortgagors or paid to the Federal Government.

Under the qualified mortgage bond arbitrage rules, where issuers establish a reserve to secure payment of the debt service on the bonds, the reserve is required to be reduced as debt service is reduced. If the sale of any investment would result in a loss exceeding the amount otherwise required to be paid or credited to mortgagors, however, the investment may be retained until it can be sold without resulting in such a loss.[9]

Transition rules under the Mortgage Subsidy Bond Tax Act of 1980

The 1980 Act provided a number of transition rules designed to permit issuers who were in the process of issuing mortgage subsidy bonds during Congress' consideration of that Act to issue the bonds without regard to the restrictions contained in the Act (including State volume limitations). In addition, the 1980 Act provided a general grandfather rule under which the restrictions contained in the Act did not apply to bonds issued before January 1, 1981, for which loan commitments were made, or construction begun, within one year from the issue date.

Reasons for Change

Mortgage subsidy bonds

Congress believed that mortgage subsidy bonds can perform a valuable function by enabling first-time homebuyers who might otherwise be unable to purchase a home, because of high interest rates, to do so. When Congress, in 1982, decided to relax certain of the restrictions on mortgage subsidy bonds, the interest rate on taxable mortgages approached 15 percent and the housing market was seriously depressed. Since that time, a significant improvement in the housing market has occurred; however, the typical fixed mortgage interest rate still exceeds 12 percent, and it remains difficult for average Americans (particularly first-time homebuyers) to purchase a residence. In this situation, Congress believed that the qualified mortgage bond program can continue to make an important contribution by making housing more affordable to low -and middle-income Americans. Accordingly, Congress decided that the qualified mortgage bond program should be extended.

In order to provide an opportunity for reassessment of the qualified mortgage bond program in light of changing conditions, Congress decided that the program should be extended for a four-year period only (i.e., for bonds issued before January 1, 1988). During this four-year period, these bonds continue to be subject generally to the same requirements as under the 1980 Act. To ensure an adequate basis for reevaluation, Congress determined that qualified mortgage bonds should be subject to reporting rules similar to the TEFRA information reporting requirements for private activity

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[9]The rule permitting retention of an investment where its disposition would result in a loss was added by TEFRA, effective for bonds issued after September 3, 1982.

tax-exempt bonds. Additionally, to ensure that the public and Congress are aware of the policies to be pursued in distributing loans made under a qualified mortgage bond program, State and local officials are required to prepare annual reports on such policies, to file such reports with the Treasury Department, and to provide reasonable public notice and hearings before issuing the reports. Finally, the Treasury Department is required to report to Congress before the 1988 sunset date regarding the performance of issuers relative to the goals of the qualified mortgage bond program.

Mortgage credit certificates

Congress was aware of studies showing mortgage subsidy bonds to be a relatively inefficient means of providing a subsidy to first-time homebuyers when it reviewed whether or not to extend the program. Additionally, Congress was aware that, because of the nature of tax-exempt financing, it may be difficult to target the subsidy provided by mortgage subsidy bonds to those most in need of housing assistance. Congress therefore decided to offer States and localities the alternative of distributing mortgage credit certificates (MCCs) in lieu of qualified mortgage bonds.

The rules for distributing MCCs have been designed to provide assistance to the same beneficiaries eligible for qualified-mortgage-bond-financed loans at a subsidy level that generally is the same as or greater than that provided by such bond-financed loans. Further, under the MCC program, the entire amount of subsidy flows directly to the first-time homebuyer, rather than part of the subsidy flowing to the first-time homebuyer and part to the investor in tax-exempt bonds and middlemen as under a bond program. Thus, MCCs will provide a larger subsidy at an equivalent, or reduced, Federal revenue cost. Additionally, by varying the amount of individual credits, State and local issuing authorities may achieve greater flexibility in targeting the subsidy to those individuals who are considered most in need. To encourage issuing authorities to distribute larger credits to those individuals most in need, the Act limits the maximum credit that an individual may receive in any year to the greater of 20 percent of the qualifying mortgage indebtedness, or $2,000; thus, only individuals purchasing lower-priced residences will be able to benefit from a credit in excess of 20 percent.

The Act generally provides States and localities the choice of issuing qualified mortgage bonds, MCCs, or any mixture of bonds and credits, according to their particular needs. However, because of the relative ease of issuing credits, Congress believed that a special rule was necessary to provide equity between States and to minimize the potential Federal revenue loss associated with MCCs. Congress therefore included a provision that limits the average credit size which may be issued in States whose mortgage bond volume limitation (because of the $200 million "safe harbor" limit) exceeds 20 percent of mortgage originations, or that actually issued fewer than $150 million of qualified mortgage bonds in 1983. This restriction prevents States or localities from issuing large credits to a relatively few eligible homebuyers, which would result in a revenue loss to the Federal Government without any guarantee that

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the credits would be targeted to those individuals most in need of housing assistance.

Congress understood that, despite the amendments made in 1982, housing cooperatives still may have difficulty complying with some of the requirements for qualified mortgage bond financing. Congress was informed that this was particularly true in the application of the first-time homebuyer limitation to cooperative housing corporations. Because of these possible problems, Congress believed that MCCs (as opposed to bonds) might provide a more attractive form of assistance for cooperative residents. Accordingly, MCCs may be used for that portion of interest on a cooperative mortgage that is deemed paid by a tenant-shareholder who otherwise qualifies for MCC assistance. To allow maximum flexibility in distributing credits, MCCs also may be used in connection with manufactured housing that meets specified dimensional requirements. These requirements were designed to ensure that MCCs may be issued to assist the financing of manufactured housing only where the units are of a type typically used as full-time residences.

To allow the greatest possible flexibility in administering the MCC program, the Act provides that the Treasury Department will administer the program pursuant to regulations. Congress intended that the procedures for distribution of MCCs will ensure that volume limitations are not exceeded, while providing flexibility to State and local governments in deciding how to utilize and issue MCCs. Congress believed that these goals may be accomplished best by imposing Federal reporting requirements, while leaving responsibility for day-to-day administration of the MCC program with the States and local issuers participating in the program. Should it prove desirable to adopt a more centralized administrative system, however, the Act specifically authorizes the Treasury Department (in its discretion) to do so.

As with the qualified mortgage bond program, Congress believed that the MCC program should be subject to review at an established future date. The Act provides, therefore, that authority to issue MCCs, together with authority to issue qualified mortgage bonds, will sunset on December 31, 1987.

Statement of program goals

To allow State and local governments continued flexibility in adapting to local conditions, the Act does not modify the prior-law eligibility standards for qualified mortgage bonds. However, the Act does include a statement of Congressional intent that issuers are expected to use qualified mortgage bond and MCC authority to the greatest extent feasible to make financing available to lower-income families who can use the loans to afford homes.

Congress believed that this policy may be implemented in various ways. First, issuers electing to exchange bond authority for MCC authority may provide higher percentage credits to lower-income families. (This policy is encouraged by the rules limiting the maximum credit size of MCCs.) Alternatively, issuers using mortgage bonds or MCCs may adopt more stringent income or purchase price limitations, or revise existing limitations to target loans to lower-income homebuyers. In addition, issuers are encouraged to develop procedures to ensure that the availability of qualified mortgage bond loans and MCCs is publicized widely, and that applications for such loans or credits are reviewed with respect to family income and assets so that lower-income families are given priority over higher-income families in receiving this assistance.

Qualified veterans' mortgage bonds

In deciding to continue the qualified mortgage bond program, Congress was concerned by the increasing volume of veterans' mortgage bonds being issued by a number of States (more than $3.5 billion in the years 1980 through 1982), and the potential for expansion of veterans' mortgage bond programs to States that had not issued those bonds in the past. To limit the potential Federal revenue loss from expansion of veterans' mortgage bond programs, Congress decided to impose limitations on these bonds that, essentially, limit their issuance to preexisting State programs and to amounts based upon previous volume levels. In addition, to limit the future use of veterans' mortgage bonds, issuance of these bonds is limited to veterans who served in active duty before 1977. Congress believed that these changes will prevent further increases in the issuance of veterans' mortgage bonds without unduly harming those States that have developed and maintained such programs. These changes also are intended to reduce the inequity between States that emphasize a veterans' bond program and those that rely primarily on qualified mortgage bonds or MCCs.

Additional rules

In extending the qualified mortgage bond program, Congress believed that it generally is no longer appropriate for State and local governments to issue bonds under the transition rules included in the Mortgage Subsidy Bond Tax Act of 1980. These transition rules were provided to permit persons who had relied on pre-1980 law to complete projects for which commitments were made before enactment of the 1980 Act. Congress believed that, with the passage of four years since that time, the circumstances that justified transitional relief in 1980 no longer exist generally.

Finally, Congress included a special provision in the Act to assist the State of Oregon in resolving a potential cash flow problem with respect to certain veterans' mortgage bonds.

Explanation of Provisions

1. Mortgage Subsidy Bond Provisions[10]

Extension of authority to issue qualified mortgage bonds

The Act extends the provision of prior law pursuant to which States and local governments were authorized to issue qualified mortgage bonds. The extended provision is effective for four years, i.e., for bonds issued from January 1, 1984, through December 31, 1987. Qualified mortgage bonds issued during this period will be subject to the same restrictions as applied to such bonds issued

[10] For purposes of this explanation, the term mortgage subsidy bonds includes both qualified mortgage bonds and qualified veterans' mortgage bonds.

before expiration of that authority on December 31, 1983, as well as the new restrictions discussed below.

The Act provides that State laws allocating qualified mortgage bond authority among issuers within the State, which laws had expired before reenactment of authority to issue such bonds, are to be treated as remaining in effect. These extensions are effective until the effective date of any new State law providing for allocation of the State's qualified mortgage bond authority. The Act also permits the Governors of Kentucky and Nevada to allocate their respective State volume limitations through December 31, 1986, and authorizes the Governor of Texas to take actions to allocate that State's volume limitation consistent with Texas law.

Congress intended that, as under prior law, if an issuing authority issued bonds and interest rates fall, the authority may renegotiate the terms of that issue with bondholders to achieve a lower interest rate without the renegotiated issue being counted separately toward the issuer's volume limitation for qualified mortgage bonds.[11]

Restrictions on issuance of qualified veterans' mortgage bonds

The Act generally restricts the issuance of qualified veterans' mortgage bonds to States that had qualified veterans' mortgage bond programs in existence before June 22, 1984 (the date of conference action on this provision). Thus, authority to issue qualified veterans' mortgage bonds is limited to programs that actually issued such bonds before June 22, 1984. Further, the volume of such bonds that a State may issue in any calendar year is limited to an amount equal to (1) the aggregate amount of such bonds issued by the State during the period beginning on January 1, 1979, and ending on June 22, 1984,[12] divided by (2) the number (not to exceed five) of calendar years after 1979 and before 1985 during which the State actually issued qualified veterans bonds.[13] For purposes of this limitation, obligations of one year or less that are used to finance property taxes are to be taken into account at 1/15 of their actual principal amount.

In addition to the State volume limitations, the Act imposes restrictions on the veterans to whom bond-financed mortgage loans may be made. Under the Act, loans may be made only to a veteran who served in active duty for any period before 1977, and (2) who applied for the loan before the later of (a) 30 years after the veteran left active service, or (b) January 31, 1985.[14] Further, under the Act, loans financed with qualified veterans' mortgage bonds may be made only with respect to principal residences, as defined for purposes of the qualified mortgage bond rules.

The Act specifies that good faith rules, similar to those applicable to certain qualified mortgage bond requirements, will apply in

[11] *See*, 130 Cong. Rec. H. 7112 (June 27, 1984) (statement of Mr. Rostenkowski), and S. 8408 (June 27, 1984) (statement of Senator Dole).

[12] This determination is made without regard to bonds issued during the calendar year (or portion thereof) during this period when the lowest volume of such bonds was issued.

[13] This determination is made without regard to any bonds issued by the State after June 22, 1984.

[14] The Act incorrectly provides that this date is January 1, 1985. It is anticipated that a technical amendment will be recommended to clarify that the correct date is January 31, 1985.

assessing compliance with the new volume limitations and other requirements applicable to qualified veterans' mortgage bonds.

Information reporting and policy statement requirements

Information reporting

The Act requires issuers of mortgage subsidy bonds (and mortgage credit certificates, discussed below)[15] to report specified information about each issue of such bonds issued by them to the Treasury Department. The statement must include (1) the name and address of the issuer; (2) the date of the issue, the amount of lendable proceeds of the issue; and the interest rate, term and face amount of each obligation that is part of the issue; and (3) any other information required by Treasury. The Act specifically authorizes Treasury to require information enabling it to determine whether interest on the issue qualified for tax-exemption and the extent to which the proceeds of the issue are made available to low-income individuals.

This information generally must be submitted no later than the fifteenth day of the second calendar month after the close of the calendar quarter in which the bonds are issued. For example, for bonds issued in December, the report would be due on February 15. The Act allows Treasury to prescribe a later date by which any of the information required in this statement may be submitted. Additionally, Treasury may provide extensions of time for providing any information where there is reasonable cause for the extension.

Annual policy statements

The Act further requires an elected legislative body or public official of each jurisdiction issuing qualified mortgage bonds (and mortgage credit certificates, discussed below)[16] to publish and to submit to the Treasury Department an annual report detailing the policies that the jurisdiction intends to follow in the succeeding year with respect to these programs. This report also must include an assessment of the jurisdiction's compliance during the preceding year with its previously established policies for these programs and with the Congressional intent that qualified mortgage bonds and MCCs be made available, to the greatest extent possible, to assist lower-income families to afford home ownership. This report must be published and submitted by the last day of the year preceding the year of issue. Before submitting the report, a public hearing must be held on the report.

Congress intended that, in the case of multiple jurisdiction issuers, the requirement of an annual report may be satisfied if the issuer files a single report with the Treasury Department. Such a multiple jurisdiction report must be signed by an elected official of each governmental unit on whose behalf bonds have been issued, or the governor of the State in which the issuer is located.

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[15] The Act does not expressly incorporate by reference the requirements of Code sec. 103A(j)(3) in the mortgage credit certificate provisions; however, these requirements (or equivalent reporting requirements) were intended to apply both to mortgage bonds and MCCs.

[16] The Act does not expressly incorporate by reference the requirements of Code sec. 103A(j)(5) in the mortgage credit certificate provisions; however, these requirements were intended to apply to both mortgage bonds and MCCs.

2. Mortgage Credit Certificate Provisions

Overview

The Act allows State and local governments to elect to exchange all or any portion of their qualified mortgage bond authority for authority to issue mortgage credit certificates (MCCs). MCCs will entitle homebuyers to nonrefundable income tax credits for a specified percentage of interest on mortgage loans incurred to finance the acquisition (or qualified rehabilitation or improvement) of the individual's principal residence. MCCs generally are subject to the same eligibility and targeted area requirements as qualified mortgage bonds.

Availability and function of mortgage credit certificates (MCCs)

General rules

MCCs are to take the form of certificates issued to eligible homebuyers. Each certificate must specify (1) the principal amount of indebtedness that qualifies for the credit (known as the certified indebtedness amount), and (2) the applicable percentage rate of the credit (known as the certificate credit rate). The certificate entitles the homebuyer to a credit against his or her Federal income tax for the specified percentage of mortgage interest paid during any taxable year, provided that the homebuyer uses the residence as a principal residence (as defined under sec. 1034). The certificate remains in effect until the homebuyer sells the residence or ceases using it as his or her principal residence.

The certificate credit rate of an MCC must be at least 10 percent, and may not exceed 50 percent, of the interest on the qualifying mortgage indebtedness. (The actual value of the credit will depend upon the amount of qualifying interest paid during any particular year.) However, if this percentage exceeds 20 percent, the dollar amount of the credit received by the taxpayer for any year may not exceed $2,000.[17] Thus, only individuals who purchase lower-priced residences may benefit from a credit rate in excess of 20 percent.

As stated above, MCCs are not refundable. Excess credits may be carried forward, however, to reduce the homebuyer's tax liability in the next three taxable years.

When a homebuyer receives an MCC, the homebuyer's deduction for interest on the certified indebtedness (sec. 163(a)) is reduced by the amount of the credit. For example, a homebuyer receiving a 50-percent credit, and making $4,000 of mortgage interest payments in a given year, would receive a $2,000 credit and a deduction for the remaining $2,000 of interest payments. Additionally, MCCs may not be used with respect to residences financed with qualified mortgage bonds, and only one MCC may be outstanding for any residence at any given time.

Under the Act, an MCC may not be used with respect to any indebtedness incurred after the close of the second calendar year following the year for which the issuer elects to trade in qualified mortgage bond authority for authority to issue MCCs.

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[17] If two or more persons hold interests in any residence, this limitation is allocated between them according to their respective interests.

Linkage

Except to the extent provided in regulations, MCCs are not available if the homebuyer is required to obtain his or her mortgage loan from a specified lender. Additionally, MCCs may be issued to finance loans for the purchase of homes in a designated development only if the developer certifies that the purchase price for a residence in the development is not higher than it would be without the availability of the MCCs. Mortgage loans between related parties do not qualify for an MCC.

Manufactured housing

The Act specifies that MCCs will be available for manufactured homes that are more than 102 inches in width, have a minimum of 400 square feet of living space, and are of a kind customarily used at a fixed location. Congress intended that MCCs not be available for recreational vehicles, campers, and other similar vehicles. Manufactured homes will not be taken into account in computing the average area purchase price or statewide volume limitation applicable to qualified mortgage bonds (and MCCs).

Cooperative housing corporations

Under the Act, MCCs are available for that portion of a tenant-stockholder's payments to a cooperative housing corporation which represent his or her proportionate share of interest (under sec. 216) on a blanket mortgage of the cooperative, provided that the tenant-stockholder is otherwise eligible to receive an MCC.

Transfer of MCCs

MCCs may not be transferred between taxpayers, except to the extent provided by regulations. However, outstanding MCCs may be reissued to the original recipient, under Treasury regulations, where the amount of the credit that will be allowable in any year as a result of such reissuance is less than the credit that would have been allowable under the original certificate.

Eligibility to receive an MCC

As stated above, MCCs are subject to the same eligibility and targeted area requirements as qualified mortgage bonds. MCCs, therefore, may be used only (1) with respect to single-family owner-occupied principal residences located within the jurisdiction of the issuing authority, (2) for new mortgages (or qualified rehabilitation and improvement loans), and (3) to finance the acquisition of residences the purchase price of which does not exceed 110 percent[18] of the average area purchase price applicable to the residence.

In general, all of the MCCs issued by an issuer must be issued to mortgagors who did not have a present ownership interest in a principal residence at any time during the three-year period ending on the date the qualifying mortgage indebtedness is incurred (the "first-time homebuyer" requirement). An exception to this rule is provided for qualified rehabilitation and home improvement loans and for residences located in targeted areas. The Treasury Depart-

[18] This limitation is increased to 120 percent in targeted areas.

ment is authorized to reduce this requirement to 90 percent if an issuer submits a plan to Treasury for administering this reduced first-time homebuyer requirement, and Treasury is satisfied that the requirement will be met under such plan.

As in the case of qualified mortgage bonds, a State or locality may establish more stringent criteria for participation in an MCC program, provided that those criteria do not violate the rules concerning limitations to particular lenders or developments. Any such additional criteria must be consistent with the goal of making credits available to those individuals most in need of a housing subsidy.

Volume limitations

General limits

Under the Act, the aggregate annual amount of MCCs distributable by a State or locality may not exceed 20 percent of the volume of qualified mortgage bond authority exchanged by the State or locality. For example, a State that is authorized to issue $200 million of qualified mortgage bonds, and that elects to surrender $100 million of that bond authority, may distribute an aggregate amount of MCCs not exceeding $20 million.

The aggregate annual amount of MCCs issued by a State or locality is determined by multiplying (1) the principal amount of the indebtedness (i.e., the certified indebtedness amount) with respect to each MCC issued by the State or locality, by (2) the certificate credit rate for each certificate, and adding the products. For example, a State with $20 million of MCC authority may distribute credits for 20 percent of the interest payments on mortgage loans having an aggregate principal amount of $100 million. The State also may issue any other mix of higher- or lower-percentage credits in an aggregate amount not exceeding $20 million (subject to the requirement that each credit percentage be between 10 and 50 percent).

Limitation on credit percentages for certain States

A special limitation applies for States (1) whose State volume ceiling for qualified mortgage bonds exceeds 20 percent of the average annual amount of mortgages for single-family owner-occupied residences originated in the State during the preceding three years, or (2) that issued fewer than $150 million of qualified mortgage bonds in 1983. For such States, the certificate credit rate of any MCC issued within the State generally may not exceed 20 percent. This limitation on individual MCCs may be waived by the Treasury Department if the MCCs are to be issued pursuant to a plan that ensures that the weighted average of the certificate credit rates for MCCs issued within the State does not exceed 20 percent. These rules are separate from the rule limiting the dollar amount of high-percentage credits to $2,000 (discussed above).

Public notification requirement

State and local housing agencies may issue MCCs only after making generally available, at least 90 days before the issuance, a proposed plan of distribution. The proposed plan must set forth the applicable eligibility requirements, the methods by which the certificates will be issued, and any other information required by the Treasury Department.

Administration of MCC programs and relationship to qualified mortgage bond programs

The MCC program will be administered as provided in Treasury Department regulations, subject to the following provisions.

Administration of volume limitations

The Act specifies that, before issuing qualified mortgage bonds or MCCs, the issuer must obtain a certification from an appropriate official designated by State law (or, where there is no such official, the Governor).[19/20]

This certification must state that the proposed issue, when added to prior issues, does not exceed the issuer's allocable portion of the State volume limitation for that year. The certification must be submitted to the Treasury Department at such time as Treasury requires by regulations.

If, after complying with the appropriate procedural requirements with respect to volume limitations, an issuer nonetheless exceeds its volume limitation for MCCs, the qualified mortgage bond volume limitation for the State in which the issuer is located is reduced for the calendar year after the year in which the Treasury Department determines an overissuance has occurred. The amount of the reduction is equal to 1.25 times the amount of excess issuance.[21]

This reduction is not required if there is a certification program in effect, pursuant to Treasury regulations, which is designed to ensure that overissuances do not occur. Additionally, the Treasury Department may waive the reduction when it determines that there was reasonable cause for the overissuance.

Administration of eligibility requirements

The Act allows the Treasury Department to establish a procedure under which the eligibility requirements for MCCs will be considered satisfied if a certification to that effect is made, under penalty of perjury. If such a certification is made, an MCC will not be revoked for failure to meet the eligibility requirements unless the MCC recipient is shown to have provided fraudulent statements to the lender. If an MCC recipient provides fraudulent information to the lender, the recipient's tax return is to be treated as a fraudulent return and the MCC is to be revoked. The governmental unit seeking to revoke an MCC has the burden of proving that the statements submitted to the lender were fraudulent.

The Act imposes penalties for misstatements made in connection with the issuance of MCCs. The amount of these penalties is $1,000 for each MCC with respect to which a negligent misstatement is made, and $10,000 for each MCC with respect to which a fraudu-

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[19] In the case of a constitutional home rule city, this certification will be made by the chief executive officer of the city.

[20] The act does not expressly incorporate by reference the requirements of Code section 103A(j)(4) in the mortgage credit certificate provisions; however, these requirements were intended to apply to both mortgage bonds and MCCs.

lent misstatement is made (in addition to any applicable criminal penalties). Statements required to be made under penalty of perjury are to contain a written declaration that the statement is so made.

Reporting requirements

Lenders making loans for which MCCs are issued must file reports with the Treasury Department containing (1) the name, address, and taxpayer identification number of the individual to whom the MCC is issued, (2) the certificate's issuer, date of issue, the certified indebtedness amount, and the certificate credit rate of the credit, and (3) other information required by Treasury.

Issuers of MCCs also are required by the Act to file reports with Treasury concerning the MCCs issued under each election. The time and manner of filing such reports and the information to be contained in the reports (e.g., the issuer's total qualified mortgage bond allocation, the date and amount of each election, the actual amount of credits issued pursuant to each election, and information regarding individual MCCs) are to be specified in Treasury regulations. Issuing authorities also are required to notify the Treasury Department of the revocation of any MCC. MCC issuers further are required to publish and submit to the Treasury annual policy statements regarding the housing, development, and income distribution policies to be followed in issuing qualified mortgage bonds and MCCs, including an assessment of the issuer's performance doing the previous year relative to the previous year's equivalent statement and relative to the overall goals of these programs.[22]

A $200 penalty is imposed on any person (including lenders or issuers) who fails to file a required report with respect to an MCC, unless the failure is due to reasonable cause and not to willful neglect. The aggregate amount of these penalties imposed on a person issuing MCCs may not exceed $2,000 in any year.

Form of MCCs

Congress intended that the Treasury Department will issue regulations prescribing the form of MCCs. Congress anticipated that these regulations will require each MCC to specify relevant information such as the following: the name of the issuer, the date of the issue, the date of the issuer's election to issue mortgage credit certificates, the name, address, and taxpayer identification number of the individual to whom the credit is issued, the address and purchase price of the property, and the certified indebtedness amount and the applicable percentage rate of the credit.

Fee and contract authority

The Act authorizes the Treasury Department to prescribe regulations that may require MCC recipients to pay a reasonable fee to cover administrative expenses. The Act further specifies that Treasury may contract with any person to provide services in administering the MCC program.

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[22] *See* the discussion of information reporting and policy statement requirements under the qualified mortgage bond provisions.

Example

One example of how the system described above might operate is as follows. An MCC issuer would obtain a certification that a proposed issue does not exceed the State volume limitation for the year in question and file an election to issue MCCs. The issuer (or a lending institution) would determine whether the applicant meets the first-time homebuyer requirement (by examining the applicant's tax returns), the purchase price limitation, and the other eligibility requirements applicable to MCCs. Where appropriate, statements by the homebuyer made under penalty of perjury could be relied upon in making this determination. The issuer or lending institution would sign a statement on the credit certificate, under penalties of perjury, that it has made the foregoing determinations and examined the applicant's tax returns. The lending institution would be responsible for entering on the MCC the principal amount of mortgage indebtedness and the interest rate on the loan. Copies of completed MCCs would be provided to the homebuyer, the lending institution, the issuer, and the State housing authority. The issuer and the lender further would be required to report to the Treasury Department information specified in Treasury regulations, as described in the preceding sections.

Alternative system

Congress intended that, in lieu of a system such as that described above, the Treasury Department, in its discretion, may adopt a centralized system of administration.[23]

Termination of MCC program

Authority to issue mortgage credit certificates terminates on December 31, 1987, together with the authority to issue qualified mortgage bonds.

3. Statement of Congressional Intent Regarding Mortgage Subsidy Bond and Mortgage Credit Certificate Programs and Required Report

The Act includes a statement of Congressional intent that State and local governments are expected to use their qualified mortgage bond and MCC authority to the greatest extent feasible (taking into account prevailing interest rates and conditions in the housing market) to assist lower-income families to afford home ownership before assisting higher-income families. The Secretary of the Treasury, in consultation with the Secretary of Housing and Urban Development, is to report to the Senate Finance Committee and the House Committee on Ways and Means, not later than January 1, 1987 (i.e., one year before the scheduled expiration of the programs) regarding the performance of qualified mortgage bond and credit issuers relative to this statement of Congressional intent.

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[23] *See*, for example, S. Prt 98-169, Vol. I (April 2, 1984), pp. 684-687.

4. Limited Authority for State of Oregon to Borrow from Federal Financing Bank in Connection with Certain Veterans' Mortgage Bonds

The Act allows the State of Oregon to borrow from the Federal Financing Bank, under specified conditions, amounts reasonably necessary to cover certain excess debt service on outstanding qualified veterans mortgage bonds. Loans made under this provision are to bear an interest rate equal to the average rate on the bonds with respect to which the borrowing occurs. No more than $300 million of such loans may be outstanding at any one time.

5. Repeal of Transition Rules under the Mortgage Subsidy Bond Tax Act of 1980

Under the Act, interest on bonds issued to finance new mortgages for owner-occupied, single-family housing after June 15, 1984, and before January 1, 1985, pursuant to the transition rules of the Mortgage Subsidy Bond Tax Act of 1980 ("1980 Act"), is not tax-exempt unless the State allocates a portion of its 1984 State volume limitation to that issue. This allocation is to be made under the general rules for allocation of the State's qualified mortgage bond volume limitation. The allocation must occur before the date of issuance of the bonds. The Act further provides that most of the transition rules under the 1980 Act will terminate for bonds issued after December 31, 1984.

Effective Dates

Mortgage subsidy bonds

The extension of authority to issue qualified mortgage bonds became effective on the date of enactment (July 18, 1984), and applies to bonds issued after December 31, 1983.

The limitations applicable to qualified veterans' mortgage bonds generally apply to bonds issued after July 18, 1984. However, the volume limitations applicable to these bonds apply to obligations issued after June 22, 1984. Additionally, under a transition rule, qualified veterans' mortgage bonds, the issuance of which was authorized pursuant to a State referendum that was (1) held before October 18, 1983, or (2) held before December 1, 1983, and authorized by action of the State legislature taken before October 18, 1983, are excluded from the volume limitations applicable to qualified veterans' mortgage bonds.

The information reporting and policy statement requirements applicable to qualified mortgage bonds and MCCs are effective for bonds and credits issued after December 31, 1984 (i.e., the first policy statement must be filed by the end of 1984, with respect to bonds and credits to be issued in 1985).

The extension of pre-1984 State allocation methods for qualified mortgage bond authority, and the rule pertaining to allocation of qualified mortgage bond authority by the Governor of Texas, became effective with respect to bonds issued after December 31, 1983. The provisions allowing the Governors of Kentucky and Nevada to allocate their respective State volume limitations became effective on July 18, 1984, and apply to bonds issued after December 31, 1983.

Mortgage credit certificates

The election for States and localities to exchange qualified mortgage bond authority for authority to issue mortgage credit certificates is effective beginning in calendar year 1984. However, the credits themselves apply only to interest paid or accrued after December 31, 1984, on mortgages executed after that date. Thus, States or localities may issue their first credits in 1985, using exchanged bond authority for 1984 and later years.

Authority to borrow from Federal Financing Bank

The limited authority for the State of Oregon to borrow from the Federal Financing Bank in connection with certain outstanding qualified veterans' mortgage bonds became effective on July 18, 1984.

Repeal of 1980 Act transition rules

The repeal of certain of the 1980 Mortgage Subsidy Bond Tax Act transition rules is effective for bonds issued after December 31, 1984.

Revenue Effect

These provisions are estimated to reduce fiscal year budget receipts by $48 million in 1984, $217 million in 1985, $498 million in 1986, $810 million in 1987, $1,017 million in 1988, and $1 billion in 1989.

B. Private Activity Bonds

(Secs. 621-632 of the Act and secs. 103 and 168 of the Code)

Prior Law

Tax-exemption for State and local obligations

Interest on State and local government obligations generally is exempt from Federal income tax (Code sec. 103). Under this provision, State and local governments may issue tax-exempt bonds to finance public projects or services (including schools, roads, water, sewer, and general improvement projects and the financing of public debt). Additionally, State and local governments may provide tax-exempt financing for certain private trades or businesses, for student loans, and for use by tax-exempt religious, charitable, scientific, or educational organizations.

Industrial development bonds

Interest on industrial development bonds (IDBs) is taxable except when the IDBs are issued for certain specified purposes. Industrial development bonds are obligations issued as part of an issue all or a major portion of which is to be used in any trade or business carried on by a nonexempt person and the payment of principal or interest on which is derived from, or secured by, money or property used in a trade or business. A nonexempt person is defined to mean all persons other than State or local governments or tax-exempt charitable, religious, educational, etc., organizations (described in Code sec. 501(c)(3)).

Exempt activity IDBs

One of the exceptions under which interest on IDBs is tax-exempt is where the proceeds of the bonds are used to finance certain exempt activities. Under this exception, interest on IDBs is tax-exempt if the bonds are used to finance the following activities: (1) certain projects for multifamily residential rental property; (2) sports facilities; (3) convention or trade show facilities; (4) airports, docks, wharves, mass commuting facilities, or parking facilities; (5) sewage and solid waste disposal facilities, or facilities for the local furnishing of electricity or gas; (6) air or water pollution control facilities; (7) certain facilities for the furnishing of water; (8) qualified hydroelectric generating facilities; (9) qualified mass commuting vehicles; or (10) local district heating or cooling facilities. In addition, interest on IDBs used to acquire or develop land as the site for an industrial park is exempt from tax.

Treasury Department regulations provide that whether the proceeds of an obligation are used for exempt facilities is to be determined by the ultimate use of the proceeds. Treas. Reg. sec. 1.103-8(a)(4). The regulations illustrate this principle by indicating that bond proceeds are used for an exempt activity where the proceeds of the bonds are loaned to banks or other financial institutions who then relend those proceeds for exempt activities (referred to as a "loan to lenders" program).

Small-issue IDBs

In general.—Interest on small-issue IDBs used for the acquisition, construction, or improvement of land or depreciable property generally is tax-exempt. This rule is referred to as "the small-issue exception."[24] This exception generally applies to issues having an aggregate authorized face amount (including certain outstanding prior issues) of $1 million or less. Alternatively, the aggregate face amount of the issue, together with the aggregate amount of related capital expenditures during the six-year period beginning three years before the date of the issue and ending three years after that date, may not exceed $10 million.[25]

In determining whether an issue meets the requirements of the small-issue exception, previous small issues and (in the case of the $10 million limitation, previous capital expenditures) are taken into account if (1) they are with respect to a facility located in the same incorporated municipality or the same county (but not in any incorporated municipality) as the facility being financed with the small-issue IDBs, and (2) the principal users of both facilities are the same or two or more related persons.

For purposes of the small-issue exception (as well as other requirements of the Code regarding tax-exempt bonds), prior law defined the term "related persons" to include family members, fiduciaries, and corporations (or partnerships) subject to common control.

Capital expenditures are not taken into account if the expenditures (1) are made to replace property destroyed or damaged by fire, storm, or other casualty, (2) are required by a change in Federal, State or local law (or the application of such laws) made after the date of issue, (3) are required by circumstances which reasonably could not be foreseen on the date of issue, or (4) are qualifying in-house research expenses (excluding research in the social sciences or humanities and research funded by outside grants or contracts).

Under prior law, the Internal Revenue Service generally ruled that, for purposes of the small-issue volume limitations, where the facilities comprising a project were owned by unrelated parties, each party was considered the principal user only of its own facility. Thus, under prior law, a project in excess of $10 million (e.g., a multistory office building) could be divided into several nominally separate facilities, each costing $10 million or less, and each separate facility could be financed by corresponding separate small issues of IDBs.

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[24] The small-issue exception does not apply to obligations a significant portion of the proceeds of which are used to provide residential rental property for family units. Thus, bonds to finance such rental property must be issued under the exempt activity rules, discussed above.

[25] In the case of facilities with respect to which an Urban Development Action Grant ("UDAG grant") is made under the Housing and Community Development Act of 1974, capital expenditures of up to $20 million are allowed.

Limitations on small-issue IDBs imposed by TEFRA.—The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), P. L. 97-248, imposed several new restrictions on small-issue IDBs. First, TEFRA provided that the small-issue exception would not apply to obligations issued after December 31, 1986. Second, TEFRA provided that the $1 million "clean limit" exemption would no longer be available for any IDB issued as part of the same issue as other obligations, the interest on which was tax-exempt under a provision other than the small-issue exception. (The alternative $10 million-limitation remained available for such combined issues.)

Third, TEFRA eliminated the small-issue exception for bonds issued after December 31, 1982, if (1) more than 25 percent of the proceeds of the issue is used to provide a facility the primary purpose of which is retail food and beverage services (including all eating and drinking establishments but not grocery stores), automobile sales or service, or the provision of recreation or entertainment, or (2) any portion of the proceeds is used to provide any private or commercial golf course, country club, massage parlor, tennis club, skating facility (including roller skating, skateboard, and ice skating), racquet sports facility (including any handball or racqetball court), hot tub or sun tan facility, or racetrack. These restrictions do not affect IDBs issued pursuant to exceptions other than the small-issue exception.

In addition to the above restrictions, TEFRA provided that multiple lots of small-issue IDBs would no longer be treated as one issue unless the proceeds are used to finance two or more facilities that (1) are located in more than one State, or (2) have the same or related principal users.[26] Under this rule, multiple lots of IDBs qualify as tax-exempt as long as each separate issue qualifies as a small issue.

Qualified scholarship funding bonds

Interest on qualified scholarship funding bonds is exempt from Federal income tax. Qualified scholarship funding bonds are obligations issued by a not-for-profit corporation established and operated exclusively for the purpose of acquiring student loan notes. For interest on the bonds to qualify for tax-exemption, the corporation must be required to use any income (after payment of expenses and debt service) to purchase additional student loan notes, or to pay over the income to the State or a political subdivision. Interest on other bonds used to provide student loans could also be tax-exempt in certain cases. (*See,* the discussion of consumer loan bonds, below.)

Cost recovery for property financed with tax-exempt bonds

Accelerated cost recovery system (ACRS) in general

Deductions from gross income are permitted for a reasonable depreciation allowance for property used in a taxpayer's trade or business or held for the production of income. Since enactment of

[26]For purposes of this rule, "principal users" include persons (other than governmental units) that (1) arrange or assist in the issuance of, or guarantee (directly or indirectly) the repayment of, any obligation used to finance the facility, and (2) provide any property, franchise, or trademark to be used in connection with the facility.

the Economic Recovery Tax Act of 1981, P. L. 97-34, cost recovery deductions for tangible personal property have been determined under the Accelerated Cost Recovery System (ACRS). ACRS permits capital cost recovery deductions over predetermined periods generally unrelated to, but shorter than, the economic useful lives of the property.

Recovery of costs under ACRS is determined by using a statutorily prescribed accelerated method. This cost recovery method approximates the benefits of using a 150-percent declining balance method for the early recovery years and the straight-line method for later recovery years. For 15-year real property, this method reflects a 175-percent declining balance method (200 percent for low-income real property) switching to the straight-line method in the later years of the recovery period.

As an alternative to ACRS, taxpayers may elect to depreciate real or personal property using the straight-line method over ACRS or statutorily prescribed extended recovery periods.

Property financed with tax-exempt bonds

TEFRA provided that property placed in service after December 31, 1982, generally is not eligible for full ACRS deductions or other accelerated cost recovery deductions, to the extent that the property is financed with tax-exempt IDBs. In lieu of full ACRS deductions (i.e., deductions based upon the accelerated cost recovery method), prior law required the cost of most personal property financed with IDBs to be recovered using the straight-line method (with a half-year convention and without regard to salvage value) over the applicable ACRS periods. For most real property, costs were required to be recovered using the straight-line method (using a monthly convention and without regard to salvage value) over the 15-year cost recovery period prescribed by prior law for real property.

Several exceptions were included under prior law pursuant to which IDB-financed facilities could continue to be benefit from full ACRS deductions. The exceptions included: (1) projects for multifamily residential rental property; (2) public sewage or solid waste disposal facilities, where substantially all of the sewage or solid waste (other than recycled waste) processed by the facility was collected from the general public; (3) air or water pollution control facilities that were installed in connection with a facility in existence on July 1, 1982, or that were used in connection with conversion of oil- or gas-fired facilities to coal (but only if the oil- or gas-fired furnace that was converted to coal was in use at the facility before July 1, 1982); and (4) facilities with respect to which an Urban Development Action Grant ("UDAG grant") was made.

The limitations on ACRS deductions, where applicable, apply both to the first owner of the property and to any subsequent owner who acquires the property while the tax-exempt IDBs (including any refunding issues) are outstanding.[27] The limitations did not apply if the taxpayer elected a longer recovery period for the property than that provided by the ACRS generally.

[27] If tax-exempt IDBs are first issued after the property is placed in service, the taxpayer is required to recompute any cost recovery deductions claimed for the property in prior years.

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Arbitrage restrictions

In general

Interest on obligations (including IDBs or other State or local obligations) that are arbitrage bonds is not tax-exempt. An arbitrage bond is defined as an obligation that is part of an issue all or a major portion of the proceeds of which are to be used (directly or indirectly) to acquire taxable obligations that produce a materially higher yield than the yield on the tax-exempt obligations (or to replace funds that are so used). Exceptions are provided for materially higher yielding obligations that do not exceed a minor portion (15 percent) of the bond proceeds and for obligations held for a temporary period.

Treasury Department regulations provide rules for determining when an obligation acquired with the proceeds of tax-exempt bonds has a yield materially higher than the bond yield. These regulations apply different arbitrage restrictions to "acquired purpose obligations" and "acquired nonpurpose obligations" acquired with the proceeds of tax-exempt bonds. "Acquired purpose obligations" are obligations acquired to carry out the purpose of the bond issue. All other obligations acquired with bond proceeds are "acquired nonpurpose obligations."

Permissible arbitrage (other than for bonds issued in connection with certain governmental programs such as student loan bonds) generally is limited so that the issuer may earn a spread between the yield on the bonds and the yield on acquired purpose obligations not exceeding 0.125 percentage points plus reasonable administrative costs. Administrative costs basically are the costs of issuing, carrying, or redeeming the bonds, the underwriter's discount, and the costs of acquiring, carrying, redeeming, or selling the obligation to the bond user. Permissible arbitrage for investments of bond proceeds in nonpurpose obligations is restricted to an amount not exceeding 0.125 percentage points plus certain costs. Additional rules apply to investments of sinking funds and other indirect and replacement proceeds of a bond issue.

There are two principal exceptions to these rules. First, unlimited arbitrage is permitted on proceeds invested for a temporary period prior to use whether held by the issuer or the user of bond proceeds. An issuer may waive the temporary period and receive an arbitrage spread of 0.5 percentage points plus allowable costs with respect to obligations subject to yield restrictions. Second, unlimited arbitrage is permitted on investments held in a reasonably required reserve or replacement fund. All amounts held in a reserve fund are applied against the 15 percent minor portion that may be invested without regard to yield restrictions. Since an issue may not be deliberately increased to take advantage of the minor portion rule, reserve funds are the most important example of a minor portion.

The permissible arbitrage earnings under prior law depended on a comparison of the yield on the bonds and the yield on the acquired obligations. Prior law permitted various deductions that increased bond yield or decreased acquired purpose obligation yield. The case of *State of Washington* v. *Commissioner*, 692 F.2d 128 (D.C. Cir. 1982), held that bond yield is the discount rate at which the present value of all payments of principal and interest on the bonds equals the net proceeds of the issue after deduction of the costs of issuing the bonds. Because costs are deducted in determining net proceeds, there is a corresponding increase in the bond yield. Therefore, under this case, the bond issuer is permitted a higher yield on the investment of bond proceeds and may pay issuance costs out of arbitrage profits.

The method of determining bond yield provided by this case does not apply for mortgage subsidy bonds, where bond yield is based on the initial offering price to the public (excluding bond houses and brokers). The yield on acquired purpose obligations is calculated by excluding payments having a present value equal to the costs of issuing, carrying, or repaying the bonds, the underwriter's spread, and the costs of purchasing, carrying, redeeming, or selling acquired obligations. The bond issuer therefore is permitted to ignore the higher yield on acquired purpose obligations used to pay these costs. The bond issuer may not use the same cost to both increase bond yield and decrease yield on acquired purpose obligations.

In the case of student loan bonds and other obligations issued in connection with certain governmental programs, prior law generally limited permissible arbitrage on acquired purpose obligations that are acquired in connection with the program (acquired program obligations) to a spread between the interest on the bonds and the interest on the acquired program obligations equal to the greater of (i) 1.5 percentage points plus reasonable administrative costs or (ii) all reasonable direct costs of the loan program (including issuance costs and bad debt losses). Special allowance payments made by the Department of Education were not taken into account in determining yield on student loan bonds. If student loan repayments were placed in a revolving fund, a new three-year temporary period commenced when each deposit to the fund was made.

Mortgage subsidy bonds

Special arbitrage rules apply in the case of mortgage subsidy bonds, in addition to the regular arbitrage rules described above. No more than 1.125 percentage points of arbitrage may be earned on the mortgages (acquired purpose obligations) acquired with bond proceeds. For this purpose, costs related to the borrowing that are borne by the mortgagors generally are treated as yield on the mortgage loans. Yield on the bond issue is determined without regard to the underwriter's discount. The amount of bond proceeds that may be invested at a yield above the bond yield in acquired nonpurpose obligations in any bond year generally is limited to 150 percent of annual debt service for the bond year. The 150 percent of debt service limit does not apply to amounts invested for a temporary period after the date of issue or to amounts in a bona fide debt service fund.

All arbitrage profits earned on acquired nonpurpose obligations (adjusted for gains and losses on such obligations and earnings on the gains and arbitrage profits) must be paid or credited to the mortgagors. Alternatively, the issuer may elect to make this payment to the United States. If the full 1.125 percentage points is not earned on the mortgage obligations, the amount to be paid to the mortgagors or the United States may be reduced by the amount by which the mortgage yield is less than 1.125 percentage points above the bond yield.

Advance refundings

Interest on advance refunding obligations generally does not qualify for tax-exemption. An advance refunding generally is defined as the issuance of bonds to retire another bond issue on a date after the issuance date of the refunding bonds. Advance refunding is defined for purposes of the IDB and mortgage subsidy bond restrictions as the issuance of obligations to refund an issue where the refunding issue is issued more than 180 days before the prior issue is redeemed. Prior law generally prohibited advance refundings of IDBs and mortgage subsidy bonds. Prior law included a special exception under which advance refundings of IDBs issued to finance convention or trade show facilities or airports, docks, wharves, mass commuting facilities, or parking facilities (sec. 103(b)(4)(C) and (D)) were permitted if the facilities financed with the IDBs generally were available to the public.

Federally guaranteed tax-exempt bonds

In general

The Public Debt Act of 1941 prohibits the Federal Government from issuing tax-exempt obligations. Since enactment of that Act, the Federal Government generally has refrained from guaranteeing tax-exempt State or municipal bonds. However, in the case of bonds the proceeds of which are deposited in Federally insured accounts or deposits in financial institutions, Federal deposit insurance could provide an effective guarantee for the bonds under prior law. In certain other cases, other Federal agencies are permitted to provide additional security for tax-exempt bonds through (1) guaranteeing of obligations that are used to secure tax-exempt bonds, (2) subordinating debts owed to the Federal Government to the tax-exempt bonds, or (3) otherwise indirectly guaranteeing tax-exempt obligations by assuming risks related to the issue of bonds. In other cases, regulations specifically prohibit guaranteeing tax-exempt obligations.

Tax-exempt IDBs guaranteed by FDIC or FSLIC

Federal deposit insurance laws

The Federal Deposit Insurance Corporation (FDIC) and the Federal Savings and Loan Insurance Corporation (FSLIC) insure deposits to a maximum of $100,000 per depositor.[28] Where assets of a trust are deposited in Federally insured institutions, the trust funds are insured up to $100,000 for each beneficial owner of the trust funds.[29] Additionally, where a public official deposits funds required to be paid to holders of bonds issued by a public unit, the interest of each bondholder is insured up to $100,000.[30]

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[28]FDIC provides insurance for deposits in commercial banks and State mutual savings banks. FSLIC insures deposits in savings and loan associations, Federal mutual savings banks, and certain other thrift institutions.

[29]12 U.S.C. sec. 1817(i) and 12 C.F.R. sec. 331(b) (FDIC); 12 U.S.C. sec. 1724(b) and 12 C.F.R. sec. 564.2(c) (FSLIC).

[30]12 C.F.R. sec. 330.8(b) (FDIC); 12 C.F.R. sec. 564.8(b) (FSLIC).

FDIC and FSLIC concluded in letter rulings issued in 1982 that, where the proceeds of a tax-exempt bond issue were used to purchase certificates of deposit of insured financial institutions (which may occur in a loan-to-lenders program), each bondholder's proportionate interest in the certificates was recognized separately. Thus, if one or more depository banks failed, the interest of each bondholder was insured up to $100,000 for each depository bank.

Typical structure of FDIC- and FSLIC-insured bonds

Under prior law, the proceeds of certain issues of tax-exempt bonds were deposited in bank, savings and loan, or credit union accounts insured by the FDIC, FSLIC or NCUA, to be loaned to the user by the depository institution. In the typical arrangement, the issuer transferred the proceeds to a trustee for the bondholders, who then deposited the funds in insured certificates of deposit. The depository institution agreed to provide the deposited funds to private users for purposes eligible for tax-exempt financing. Interest and principal on the bonds were repaid from payments on the certificates of deposit. The repayment of the bonds was secured by the certificates of deposit. Because the trustee for the bondholders held a certificate of deposit in an insured institution, the amount of each bondholder's holdings was insured to the extent of $100,000. Because the proceeds of the bonds were used ultimately for exempt purposes, the interest on the bonds was tax-exempt.

Small Business Administration guarantees

The Small Business Administration (SBA) is authorized to guarantee 100 percent of the payments due from eligible small businesses under contracts for the planning, design, or installation of governmentally mandated pollution control facilities.[31]

HUD guarantees

Rental subsidies

Section 11(b) of the Housing Act of 1937 [32] provides that obligations issued by State and local housing agencies in connection with low-income housing projects are exempt from income Federal tax. The 1937 Act prohibits the Department of Housing and Urban Development (HUD) from guaranteeing any tax-exempt obligation issued by a State or local agency.[33] However, under certain circumstances, an issuer may pledge HUD loans or contributions (which are backed by the full faith and credit of the United States) as security for tax-exempt obligations, and thereby receive the substance, if not the form, of a Federal guarantee.

Mortgage insurance

In addition to the above program, the Federal Housing Authority (FHA) is authorized to insure mortgages on various properties, including certain owner-occupied housing, rental and cooperative housing, housing for moderate income and displaced families, hous-

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[31] Small Business Investment Act of 1958, 15 U.S.C. sec. 694-1.
[32] 42 U.S.C. sec. 1437i(b).
[33] 42 U.S.C. sec. 1437i(b).

ing for elderly persons, and hospitals and nursing homes.[34] Mortgages insured by FHA may include mortgages on properties constructed with tax-exempt financing. In these situations, FHA-insured mortgages may be pledged as security for tax-exempt bonds.

Veterans' Administration guarantees

The Veterans' Administration (VA) is authorized to insure mortgages on various properties owned by veterans of the U.S. Armed Forces and their families. VA-insurance is permitted on mortgage loans for certain properties constructed with tax-exempt financing. In those cases, the VA-insured mortgages may be pledged as security for repayment of the tax-exempt bonds.

Student loan bond guarantees

The Department of Education guarantees repayment of various forms of student loans. In certain cases, Federally guaranteed student loans may be pledged as security for repayment of tax-exempt bonds.

Department of Agriculture (Farmers Home Administration) guarantees

The Farmers Home Administration (FmHA) guarantees loans for various agricultural purposes, including emergency loans, farm operating loans, farm ownership loans, soil and water conservation loans, business and industrial loans, economic emergency loans, and guaranteed rural housing loans. Since 1982, FmHA has provided administratively that it will not guarantee loans made with the proceeds of tax-exempt obligations.[35] Additionally, no FmHA loan is permitted to be used as collateral for a tax-exempt issue.

Energy program guarantees

Under certain energy production or conservation programs, the Federal Government is authorized to guarantee the payment of principal or interest on bonds used to finance qualified hydroelectric generating facilities or qualified steam-generating or alcohol-producing facilities. The Internal Revenue Code (sec. 103(h)) eliminates the tax-exemption for interest on bonds guaranteed under these programs. Additionally, the tax-exemption is eliminated when principal or interest on the bonds is to be paid with funds provided by the Federal Government (or by State or local governments) under an energy production or conservation program.

Tax-exemptions provided other than in the Internal Revenue Code

In addition to the tax-exemptions provided under the Internal Revenue Code, certain nontax statutes provide exemptions for interest on specified obligations or deem bonds issued under such non-tax statutes to satisfy some or all requirements of the Code for tax-exemption. Under prior law, obligations for which tax-exemption was provided other than in the Internal Revenue Code generally were not subject to the restrictions on tax-exempt bonds contained in the Code.

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[34] National Housing Act of 1934, 12 U.S.C. sec. 1707 et seq.
[35] 7 CFR sec. 1980.23.

District of Columbia Bonds

Under the District of Columbia Self-Government and Governmental Reorganization Act, P. L. 93-198, the District of Columbia is authorized to issue (1) general obligation bonds and (2) revenue bonds and notes for use in the areas of housing, health, transit and utility facilities, recreational facilities, college and university facilities, pollution control facilities, and industrial and commercial development. Under that Act, the obligations are exempt from all Federal and District taxation (except gift and estate taxes).[36]

In 1976, the Internal Revenue Service held that interest on obligations issued by the District of Columbia was exempt from Federal income taxes notwithstanding the industrial development bond restrictions of the Internal Revenue Code.[37] Thus, for example, the District of Columbia was permitted to issue bonds for industrial and commercial development without regard to the limitations on small-issue IDBs; however, these bonds were subject to an arbitrage limitation. Because of general questions concerning home rule in the District of Columbia as a result of the decision in *INS* v. *Chadha*,[38] the authority of the District to issue tax-exempt bonds was unclear.[39]

Possessions bonds (Puerto Rico, the Virgin Islands, and Guam)

Under the Puerto Rico Federal Relations Act,[40] bonds issued by the Government of Puerto Rico, or by its authority, are exempt from Federal, State, and Puerto Rican taxation. Under prior law, the government of the Virgin Islands was authorized to issue tax-exempt general obligation bonds for public works, slum clearance, urban redevelopment, and low-rent housing, but not tax-exempt IDBs. The government of Guam also has authority to issue obligations that are exempt from Federal, State or Guam taxation.[41]

Housing and Urban Development Bonds

As discussed above in the explanation of HUD guarantees of tax-exempt bonds, certain obligations issued by State and local public housing agencies to finance construction by private for-profit entities of low-income housing projects were exempt from Federal tax, pursuant to section 11(b) of the Housing Act of 1937 under prior law.[42] This exemption is limited to projects developed, acquired, or assisted by the State or local agency. The project units generally must be rented to families whose incomes do not exceed 80 percent of the median income for the area (as determined by the Department of Housing and Urban Development).

Certain obligations issued by State and local public housing authorities that did not involve private for-profit entities also were

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[36] D.C. Code sec. 47-332.
[37] Rev. Rul. 76-202, 1976-1 C.B. 26.
[38] 462 U.S. 919 (1983).
[39] Sec. 647 of the Act authorizes the District of Columbia to issue certain tax exempt bonds for housing notwithstanding the *Chadha* decision.
[40] Laws 1917, ch. 145, 39 Stat. 953 (48 U.S.C. sec. 745).
[41] P. L. 418, 81st Cong., 1st Sess. (1949) (48 U.S.C. sec. 1403).
[42] 42 U.S.C. sec. 1437i(b).

tax-exempt pursuant to section 11(b). These projects were owned and operated by the State or local public housing agency.

State and local public agencies also issued obligations for slum clearance purposes. These obligations were exempt from tax pursuant to section 102(g) of the Housing Act of 1949. This program was terminated in 1972, but the obligations have continued to be refunded on a short-term basis since that time.

Additional restrictions on private activity bonds imposed by TEFRA

In addition to providing the new restrictions on small-issue IDBs, and on cost recovery for IDB-financed property, discussed above, TEFRA made several changes in the rules concerning IDBs generally. First, TEFRA required that issuers of all private activity bonds (including IDBs, scholarship funding bonds, and bonds issued by charitable organizations exempt from tax under sec. 501(c)(3)) make quarterly information reports to the IRS concerning bonds issued by that issuer. TEFRA also required that issuance of IDBs be approved by an elected official in the issuing jurisdiction, and in all jurisdictions where the facilities financed with the bonds are to be located, following a public notice and hearing (or that issuance be approved pursuant to a voter referendum). In addition, the average length of time to maturity of IDBs generally was limited by TEFRA to 120 percent of the economic life of the property financed.

Other private activities for which tax-exempt bonds could be issued under prior law

Prior law generally did not restrict the use of tax-exempt bonds to finance personal loans to individuals for nonbusiness purposes. Because the proceeds of such loans generally were not used in the conduct of a trade or business, these bonds were not subject to the restrictions applicable to IDBs. However, as discussed in Part A., above, a number of restrictions were imposed on the use of tax-exempt bonds to provide financing for owner-occupied residences (sec. 103A).

Reasons for Change

General considerations

Congress was extremely concerned with the volume of tax-exempt bonds used to finance private activities. The volume of these bonds has increased sharply over the past few years—from $6.2 billion in 1976 to $62.4 billion in 1983. During this same period, private activity bonds increased from 21 percent of total State and local borrowings in 1975 to 68 percent in 1983. The TEFRA limitations on private activity bonds (including the public notice and approval requirements, information reporting requirements, the limitations on cost recovery, and the limitations on small issue IDBs) restricted the benefits associated with certain IDB-financed projects and eliminated some of the abuses associated with private activity bonds. However, Congress determined that the TEFRA rules appeared unlikely to impose adequate limits on the overall growth in the volume of private activity bonds.

The rapid growth of private activity bonds was a source of concern to Congress for several reasons. First, the mounting volume of private activity tax-exempt bonds has resulted in an increasing revenue loss to the Federal Government. Because a substantial portion of the benefits of tax-exemption flows to the investor or other intermediaries (e.g., bond counsel and investment bankers), tax-exempt bonds are a relatively inefficient means of providing a subsidy to the beneficiary of the tax-exempt financing.

Second, Congress was concerned that the expanding volume of private activity bonds has inflated tax-exempt interest rates, thereby increasing the costs of State and local borrowing for traditional public purposes (schools, roads, public projects, etc). Competition from private activity bonds could, therefore, force State and local governments to choose between raising taxes in order to meet increased borrowing costs or providing a lower level of services.

Finally, Congress determined that the availability of tax-exempt financing for certain types of projects had tended to encourage investment in such projects independent of the economic value of the project. Such financing was, therefore, diverting investment capital from more productive uses.

Volume limitations for IDBs and student loan bonds

To prevent further unrestrained growth in private activity bonds, Congress believed that meaningful limitations should be imposed on the overall volume of private activity tax-exempt bonds. However, Congress determined that the decision as to what types of projects should be financed is best made by the appropriate State or local government. To achieve its goals, Congress decided to impose a volume limitation for each State, effective for bonds issued after 1983, on the overall volume of certain private activity bonds that may be issued. The limitation, set initially at the greater of $150 for each resident of the State or $200 million applies to most industrial development bonds and student loan bonds issued within the State. (Qualified mortgage bonds are not subject to this limitation because these bonds have been subject to separate statewide volume limits since 1980.)

Within each State's volume limitation, and within the other restrictions applicable to private activity bonds, State and local governments are free to issue bonds to finance activities that they determine serve the greatest public benefit. Congress believed that this volume limitation will impose meaningful limits on the growth of tax-exempt bonds without impinging unnecessarily on State and local prerogatives. Further, Congress believed that the limitation will result in tax-exempt financing being provided to those projects that best serve the public interest.

While desiring to limit the growth of private activity bonds, Congress was aware that the Code definition of IDBs may encompass certain facilities that traditionally have been considered public facilities and that perform essentially public functions. Congress also was aware that certain of these facilities are large, one-time projects that may be particularly difficult to finance under a volume limitation. To prevent hardships of this sort, the Act includes an exception from the volume limitation for IDBs used to finance convention, trade show, and certain transportation facilities if no person other than a governmental unit owns the facilities being financed.

In providing this exception, Congress believed it appropriate, because advance refundings result in twice the amount of bonds outstanding with respect to a facility, to repeal the prior-law provision that permitted for advance refunding of bonds used to finance these and certain other related types of facilities.

Congress recognized the importance of tax-exempt bonds in financing multifamily residential rental property for low -and moderate-income individuals. Thus, bonds issued for this purpose are not subject to the volume limitation and certain other restrictions imposed by the Act. Congress also believed that private nonprofit organizations (described in sec. 501(c)(3)) should continue to benefit from tax-exempt financing. This belief is consistent with the general treatment of these organizations, which are exempt from Federal income tax and are (in most cases) entitled to receive tax-deductible contributions. Accordingly, Congress decided that bonds issued to provide financing for section 501(c)(3) organizations (other than bonds the proceeds of which are used in an unrelated trade or business) should not be subject to the statewide volume limitation.

Congress was aware that some States had issued bonds in excess of their statewide volume limitation in 1983. Congress believed that these states should be allowed a reasonable period in which to adjust to the new limitation. The Act therefore allows these States to phase down to the applicable limit so that all States are subject fully to the limitation beginning in 1985.

Further restrictions

In addition to the overall volume limitation on certain private activity bonds, Congress believed that a number of additional restrictions and modifications to the existing restrictions applicable to tax-exempt financing were needed.

Federally guaranteed tax-exempt obligations

First, Congress was concerned by the combination of tax-exempt financing with Federal guarantees. This combination resulted in a double subsidy for certain activities. Since Federally guaranteed tax-exempt bonds are more attractive than United States Treasury securities (the interest on which is taxable) and other State and local obligations (which do not have Federal guarantees), the proliferation of such bonds could have made it difficult for both the Federal and State governments to raise needed funds. Congress determined, therefore, that interest on bonds where principal of or interest on the issue is guaranteed, in whole or in part, directly or indirectly, by the Federal Government generally should be taxable. The use of the proceeds of tax-exempt bonds to make loans where debt service on the loans is guaranteed in whole or in part generally is prohibited under the Act. This prohibition also applies to tax-exempt bonds the proceeds of which are deposited in Federally insured financial institutions, thereby receiving an effective guarantee (e.g., through FDIC or FSLIC). However, Congress decided that continued availability of Federal guarantees of bonds for certain housing-related programs, for student loans, and for the SBA pollution control programs, was necessary for the success of the related programs and should not be subject to the general prohibition.

Limitations on cost recovery deductions

Congress believed that the general rule provided by TEFRA that the cost of IDB-financed property should be recovered using the straight-line method over ACRS lives is appropriate because the combined benefits of tax-exempt financing and full ACRS deductions provide an unnecessarily large subsidy. Congress concluded that most of the exceptions to that rule were unnecessary. However, Congress determined that multifamily residential rental property financed with tax-exempt bonds should continue to be eligible for full accelerated cost recovery deductions.

Restrictions on new private activities financed with tax-exempt bonds

Congress believed that, in light of the current budgetary situation and its overall decision that the use of tax-exempt bonds should be restricted, it should review and approve in advance all purposes for which tax-exempt financing is available to persons other than exempt persons. Congress viewed the dramatic growth in issuance of mortgage subsidy bonds before enactment of the restrictions of the Mortgage Subsidy Bond Tax Act of 1980 as a case in point. Congress determined, therefore, that tax-exemption should be eliminated for interest on all bonds if more than five percent of the proceeds is used for a purpose benefitting a nonexempt person and if that purpose has not been approved specifically by it.

Miscellaneous changes

Congress also determined that other restrictions (in addition to those imposed by TEFRA) should be imposed on private activity bonds. These restrictions are designed, in part, to prevent the aggregation of small issue bonds so as to provide extensive amounts of financing for one large-scale project. In addition, the Act tightens the arbitrage restrictions on certain tax-exempt IDBs and student loan bonds by enacting additional arbitrage rules governing investment of bond proceeds in obligations not related to the governmental purpose for which the bonds were issued.

Congress further determined that a limited extension of the small-issue exception in the case of bonds the proceeds of which are used to finance manufacturing facilities is consistent with the need to sustain the country's current economic recovery. Finally, the Act limits the use of IDBs to acquire land and existing facilities, subjects bonds with respect to which tax-exemption previously was provided other than in the Internal Revenue Code to Code provisions, and makes certain other changes in the law regarding private activity tax-exempt bonds.

Explanation of Provisions

1. Private activity bond volume limitation

In general

The Act limits the aggregate volume of private activity bonds, i.e., certain tax-exempt industrial development bonds (IDBs) and student loan bonds, that each State (including U.S. possessions) may issue during any calendar year. This limitation does not apply to IDBs the proceeds of which are used to finance projects for multifamily residential rental property (sec. 103(b)(4)(A)). This exception includes public housing program obligations issued under section 11(b) of the United States Housing Act of 1937.

The volume limitation also does not apply to IDBs the proceeds of which are used to finance convention or trade show facilities or airports, docks, wharves, or mass commuting facilities (sec. 103(b)(4)(C) and (D)), but only if the property financed by the IDBs is owned by or on behalf of[43] a governmental unit. For this purpose, publicly owned mass commuting vehicles that are associated with qualified mass commuting facilities are included in the definition of section 103(b)(4)(D) property. The exception from the volume limitation does not apply to parking facilities financed with IDBs under section 103(b)(4)(D) of the Code. However, parking facilities that are functionally related and subordinate to a facility that qualifies under the exception (e.g., airport parking facilities) are included within the exception if the parking facilities satisfy the same requirements for tax-exemption (i.e., no nongovernmental ownership) as the facility to which they are subordinate.

IDB-financed property is considered owned by or on behalf of a governmental unit if no nongovernmental entity is considered an owner of the property for Federal income tax purposes. Therefore, no taxpayer may be entitled to cost recovery deductions or an investment tax credit for any portion of the property. For purposes of this rule, property shall not be treated as owned other than by or on behalf of a governmental unit solely by reason of the length of the lease to which it is subject if the lessee makes an irrevocable election (binding on the lessee and all successors in interest under the lease) not to claim cost recovery deductions or an investment tax credit with respect to such property. Facilities may qualify for the exception even if the governmental unit's obligation to pay interest and principal on the bonds is limited to revenues from fees collected from users. The Act directs the Treasury Department to prescribe regulations pursuant to which facilities will be considered *not* owned by or behalf of a governmental unit if rents charged to tenants are front-loaded to achieve an effect more accelerated than a straight-line rent over the life of the property.

For purposes of the volume limitation, student loan bonds include any obligation that is issued as part of an issue all or a major portion of the proceeds of which are used directly or indirectly to finance loans to individuals for educational expenses.

The volume limitation does not apply to obligations that are neither IDBs nor student loan bonds (e.g., bonds issued by organiza-

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[43] See Rev. Proc. 63-20, 1963-2 C.B. 754.

tions described in section 501(c)(3)) for use other than in unrelated trades or businesses and bonds issued to finance traditional governmental activities).[44]

Allowable bond volume

The annual volume limitation for each State is equal to the greater of (1) $150 for every individual who is a resident of the State as determined by the most recent estimate of the State's population by the Bureau of the Census as of the beginning of the calendar year to which the limitation applies, or (2) $200 million. The $150 per capita limitation continues until 1987, at which time that amount will be reduced to $100 to reflect the termination of the small-issue exception for other than manufacturing facilities (the $200 million limitation will not be reduced at that time).

For purposes of the volume limitation, the District of Columbia is to be treated as a State (and therefore is entitled to a $200 million volume limitation). However, U.S. possessions (e.g., Puerto Rico, the Virgin Islands, Guam, and American Samoa) are limited to the $150 per capita amount.

Phase-in of limitation

For States whose annualized issuance of IDBs and student loan bonds subject to the volume limitation based on first nine months of 1983 was more than the State's volume limitation under the Act, a special phase-in rule applies. Under the phase-in rule, the amount of bonds that may be issued in such States in 1984 is equal to the applicable limitation (determined under the general rule) plus one-half of the difference between the 1983 issuance level as determined above and the applicable volume limitation). Thus, by 1985, all States will be limited as determined under the general volume limitation rule.

Allocation of volume limitation among various governmental units

In general

The State volume limitation is allocated among the various governmental units within the State that are authorized to issue IDBs or student loan bonds pursuant to a three-step rule.

This allocation is the same as that provided for mortgage subsidy bonds. Under the first step, each State's limitation is allocated equally between the State (and its agencies) and localities authorized to issue bonds until either the governor or the legislature makes a different allocation. (The subsequent allocation for a particular year would be reduced by bonds issued under the first allocation.) One-half of the State limitation is allocated to the State (and its agencies having authority to issue IDBs or student loan

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[44] The State of Texas has a program called the Texas Veterans' Land Bond Program under which general obligation bonds are issued for the purchase of land. Loans under this program are limited to $20,000 per veteran. Where the proceeds of such a bond issue, other than an amount that is not a major portion of the proceeds, are used, for example, for the acquisition of land for recreational or other nontrade or business purposes of its owners, the issue would not be subject to this State volume limitation. The use of the proceeds by a veteran may be established by an affidavit of the veteran unless there is actual knowledge or reasonable information that would indicate a different usage.

bonds). The other one-half of the State volume limitation is allocated to localities having authority to issue IDBs or student loan bonds.

This allocation is made on the basis of the relative populations of those localities. The population estimates to be used in allocating the volume limitation are the most recent population estimates from the Bureau of the Census available before the beginning of the calendar year to which the determination relates. When a determination involves comparison of the population of two or more jurisdictions, data for the same year must be used.

Where there are two overlapping local governmental units, the volume limitation is allocated first to the governmental unit with jurisdiction over the smallest geographical area. The volume limitation for that jurisdiction is determined by multiplying the one-half of the State limitation by a fraction, the numerator of which is the most recent population estimate of that governmental unit and the denominator of which is the population of the entire State using that same data. The remaining portion allocable to the governmental unit with jurisdiction over the larger area is equal to one-half of the State volume limitation multiplied by a fraction the numerator of which is the population of the larger governmental unit not residing in the smaller governmental unit and the denominator of which is the population of the entire State.

Where two governmental units have authority to issue IDBs or student loan bonds and both governmental units have jurisdiction over the identical geographical area, the portion of the State volume limitation allocable to that area is allocated to the governmental unit having the broader sovereign powers. For example, where a city and an IDB authority for the city both are authorized to issue IDBs, then the portion of the State ceiling allocable to the city based upon the population of that city is allocated to the city since the city has broader sovereign powers than the IDB authority.

Under the second step, the governor of each State is provided interim authority to allocate the State volume limitation among all of the governmental units (both State and local) having authority to issue private activity bonds. This power of the governor to allocate the State limitation terminates after the first day of the calendar year beginning after 1983, during which the State legislature met in regular session for more than 60 legislative days. This authority terminates earlier than this date if State legislation having an earlier effective date is enacted. If the legislature has met and adjourned *sine die* before 60 legislative days after enactment, however, the power of the governor terminates after the first day of the first calendar year beginning after the year in which the legislature next meets for more than 60 legislative days.

Under the third step, the State legislature may enact a law providing for a different allocation than that provided in step one. Under this authority, the State legislature may allocate all or any portion of the State limitation to any governmental unit in the State that has authority to issue IDBs or student loan bonds.

The State legislature, governor, or other official designated in a State statute may allocate bond authority retroactively for bonds issued in 1984 (i.e., may allocate bond authority to projects for which bonds already have been issued). However, bonds issued before the date of enactment in 1984 (or, if earlier, the date of State action to allocate the State volume limitation) may not be denied an allocation to the extent of the bond authority the issuer would receive based upon population (i.e., if the allocation under the first step above had remained in effect).

A State may allocate available authority to a local issuer only until a specified date during each year (e.g., November 1) at which time the authority, if unused, would revert to the State for reallocation. Similarly, a State statute may provide discretionary authority to a public official (e.g., the governor) to allocate the State's volume limitation. Because the volume limitations are annual amounts, however, any authority that has not been used for bonds issued before the end of the calendar year lapses (unless a special carryforward election, discussed below, has been made).

Special rule for constitutional home rule subdivisions

The Act provides a special allocation rule for certain political subdivisions with home rule powers under a State constitution. The home rule subdivisions to which the special allocation rule applies are those home rule subdivisions that are granted home rule powers by the beginning of the calendar year in which the bonds are issued pursuant to a State constitution that was adopted in 1970 and became effective on July 1, 1971 (Illinois). In that State, a full portion of the State volume limitation is allocated to each home rule subdivision based upon the ratio that the population of that home rule subdivision bears to the population of the entire State. As is true of the other volume limitation determinations, this allocation is made using the most recent population estimate from the Bureau of the Census available before the beginning of the calendar year to which the bonds relate. The amount so allocated to home rule subdivisions may not be altered by the power to provide a different allocation otherwise granted by the Act to the governor or the State legislature. However, a home rule subdivision may agree to a different allocation.

The portion of a State's volume limitation not allocated to constitutional home rule subdivisions then is allocated among the other governmental units in the State having authority to issue private activity bonds under essentially the same three steps described in the previous section. Thus, under the first step, one-half of the remaining State limitation is allocated to the State and its agencies. The other one-half of the remaining State limitation is allocated to the localities outside of the home rule subdivisions based upon the ratio that the populations of those localities outside of home rule subdivisions bears to the population of the State's residents located outside of home rule subdivisions. Under the second and third steps described above, the governor or the State legislature may allocate the State limitation other than that allocated to home rule subdivisions to any governmental units that have authority to issue IDBs or student loan bonds (including home rule subdivisions), but they may not allocate any amount specially allocated to the home rule subdivisions.

Prohibition of bribes, etc., in return for allocation

Interest on private activity bonds issued pursuant to an allocation of any portion of a State volume limitation is nonetheless taxable unless the public official (if any) responsible for the allocation certifies, under penalty of perjury, that the allocation is not made in consideration of any bribe, gift, gratuity, or direct or indirect contribution to any political campaign. Any person willfully making an allocation in consideration of any bribe, gift, gratuity, or direct or indirect contribution to any political campaign will be subject to criminal penalty as if the allocation were a willful attempt to evade income tax.

Refunding issues

In general, all private activity bonds (other than those for which exceptions are provided) issued during a calendar year, are subject to the State's volume limitation. Refunding bonds that are not subject to the State volume limitation are any obligations that are issued to refund another obligation to the extent that the refunding obligation does not exceed the then outstanding principal amount of the refunded obligation. In the case of student loan bonds, refunding bonds are not subject to the State limitation only if the maturity date of the refunding obligation does not exceed (i) the maturity date of the refunded obligation, or (ii) the date that is 17 years after the date on which the refunded obligation was issued (or, in the case of a series of refundings, the date on which the original obligation was issued). Under this exception, for example, an IDB is a tax-exempt refunding obligation only if the proceeds of the IDB are used to retire the refunded IDB within 180 days of the date of issue. Advance refunding bonds are not covered by the exception.

Three-year carryforward

An issuer may elect to carry forward for up to three years any unused State bond authority for specific projects. The election, once made, is irrevocable. The election may not be made for projects to be financed with small-issue IDBs. A special rule permits a longer six-year carry forward for certain specifically identified air or water pollution control projects. Where the election applies, obligations issued in the three (six) calendar years following the calendar year for which the election is made are not counted towards the State's volume limitation for those three (six) calendar years to the extent that the proceeds from those obligations are used to finance the project specified in the election. The unused bond authority is absorbed in the order in which the obligations for the specified project are issued.

The election to carry forward unused State volume limitation is to be made as provided in Treasury Department regulations. Identification of a project by its address, name of intended owner, lessee, etc., and general type of facility generally will be adequate specification. The purpose of issuing student loan bonds is considered a separate project that is adequately specified for purposes of the carryforward election.

Except as provided above, no part of any State's volume limitation may be carried forward to any portion of a succeeding year. Similarly, a State may not borrow against future volume limitations.[45]

2. Restriction on cost recovery deductions for property financed with IDBs

The Act repeals three of the four exceptions to the rule requiring the cost of IDB-financed property to be recovered on the straight-line method over the applicable ACRS period. The exceptions repealed by the Act are those for certain municipal sewage and solid waste disposal facilities, certain pollution control facilities on existing property, and certain UDAG-assisted projects. Under the Act, the cost of these facilities must be recovered using the straight-line method over ACRS periods. The cost of multifamily residential rental property (as defined in sec. 103(b)(4)(A)) may continue to be recovered using the accelerated cost recovery rule under the ACRS system.[46]

3. Denial of tax exemption for interest on obligations issued with a Federal guarantee

General rule

The Act provides generally that interest on any obligation is not tax-exempt if the obligation is Federally guaranteed. An obligation is treated as Federally guaranteed if (1) the payment of the principal or interest on the obligation is guaranteed, in *whole or in part*, by the United States or any agency or instrumentality thereof; (2) a significant portion of the proceeds of the issue of which the obligation is a part are to be used in making loans or other investments the payments on which are guaranteed in whole or in part by the United States or any agency or instrumentality thereof; (3) a significant portion of the proceeds of the issue are to be invested, directly or indirectly, in Federally insured deposits or accounts in a financial institution; or, (4) the payment of the principal or interest of the obligation is otherwise *indirectly* guaranteed, in whole or in part, by the United States or an agency or instrumentality thereof. These rules apply to all obligations that are issued by or on behalf of States and their political subdivisions or that otherwise are described in Code section 103.[47]

Congress intended that the determination of whether a Federal guarantee exists be based on the underlying economic substance of the transaction, taking into account all the facts and circumstances in this regard. The transfer of risk to the Federal Government is a key element in determining whether such a guarantee exists.

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[45] Act section 644 provides the only exception to the general prohibition on advance use of a State's volume limitation, for the Long Island Lighting Company.

[46] The prior-law 15-year recovery period for IDB-financed real property inadvertently was not conformed to the 18-year period provided by section 111 of the Act for real property generally (sec. 168(f)(12)). It is anticipated that a technical amendment will be recommended to conform this provision. (To the extent that low-income housing remains eligible for 15-year cost recovery generally, the cost of such property financed with the proceeds of tax-exempt bonds also may be recovered over a 15-year period.)

[47] Obligations subject to the Code restrictions by virtue of section 103(m), as amended by the Act, also may not be Federally guaranteed unless a specific exception is provided in the Code.

Except as otherwise provided in Treasury Department regulations, an entity with Federal statutory authority to borrow from the United States generally is treated as an instrumentality of the United States. Congress intended that these regulations will deny tax-exemption only when an entity has a Federally granted right to borrow from the United States. For example, the mere ability to apply for a loan available to a broad class of entities, and which is awarded based on an objective determination of creditworthiness, is not to be construed as a "right" to borrow from the United States. In addition, for purposes of the rules, a "Federally insured financial institution" means any bank, credit union, mutual savings bank, cooperative bank, domestic building and loan association, or other savings institution whose deposits or accounts are insured under Federal law.

Federally insured deposits or accounts include all deposits or accounts in a financial institution to the extent the deposits or accounts are insured under Federal law by the Federal Deposit Insurance Corporation (FDIC), the Federal Savings and Loan Insurance Corporation (FSLIC), the National Credit Union Administration (NCUA), or any similar Federally chartered corporation. This prohibition on investment of bond proceeds in Federally insured deposits or accounts generally applies to all private activity bonds subject to the reporting requirements of TEFRA and to qualified mortgage bonds and veterans' mortgage bonds.

Exceptions

The Act provides a number of exceptions to the general restriction on Federal guarantees of tax-exempt bonds. First, the restriction does not apply to any obligations that would be treated as Federally guaranteed solely because the loans financed with the proceeds of the obligations are guaranteed by the Federal Housing Administration (FHA), the Veterans' Administration (VA), the Federal National Mortgage Association (FNMA), the Federal Home Loan Mortgage Corporation (FHLMC), or the Government National Mortgage Association (GNMA).

Second, this restriction does not apply to any guarantee of student loans or to any guarantee made by the Student Loan Marketing Association (SLMA) in order to finance student loans.

Third, the restriction does not apply to guarantees by the Small Business Administration (SBA) with respect to qualified contracts for pollution control facilities (within the meaning of sec. 404(a) of the Small Business Investment Act of 1958, as in effect on July 18, 1984) if the SBA Administrator charges a guarantee fee equal to or exceeding one percent of the amount guaranteed.

Fourth, an exception to the restriction is provided for guarantees pursuant to the Northwest Power Act (16 U.S.C. 839d) as in effect on July 18, 1984. This exception is limited to guarantees of obligations issued before July 1, 1989.

An additional exception is provided for any guarantee in connection with obligations the proceeds of which are used to finance projects for multifamily residential rental property (as described in sec. 103(b)(4)(A)) or in connection with public housing program obligations (under sec. 11(b) of the United States Housing Act of 1937). A similar rule is provided for qualified mortgage bonds and qualified veterans' mortgage bonds (sec. 103A). Therefore, interest on these bonds may be tax-exempt even if the underlying mortgages are pooled and repayment of the pooled mortgages is Federally guaranteed. This exception does not apply, however, to any obligation, the proceeds of which are invested in a Federally insured deposit or account.

In addition to these specific program exceptions, the restriction on Federal guarantees does not apply to bonds solely because the proceeds are invested in Federal obligations during an initial temporary period, or are invested in a bona fide debt service fund or a reasonably required reserve or replacement fund (sec. 103(c)(4)(b)). The restriction also does not apply to the extent the bond proceeds are invested in Treasury obligations issued to State and local governments as book entries on which they may specify interest rates (e.g., so called "SLGS"), in Federal Government obligations purchased directly from the Treasury, or in other investments permitted under Treasury Department regulations.

A further exception provides that obligations are not treated as Federally guaranteed solely because the proceeds are used in making loans to financial institutions (e.g., as part of a loans-to-lenders program) or solely because a financial institution guarantees repayment of the loans other than by means of Federal deposit insurance (e.g., by a letter of credit).

The Act provides that the District of Columbia and the U.S. possessions (including Puerto Rico, the Virgin Islands and Guam) are not considered instrumentalities of the United States, under the rules pertaining to Federal statutory authority to borrow from the United States. However, this exception does not apply to private activity bonds. Thus, under the Act, the District of Columbia or a U.S. possession having statutory authority to borrow from the U.S. may issue tax-exempt bonds, other than private activity bonds, subject to the same limitations as apply to obligations issued by States. In addition, the District of Columbia or a U.S. possession may issue private activity bonds if the bonds are not guaranteed by the governmental entity involved. This determination is made under the general rules regarding Federally guaranteed obligations. For example, private activity bonds secured only by revenues from the financed project are not treated as guaranteed by the issuing governmental entity, but such bonds secured by general revenues of the issuing government are treated as so guaranteed.[48]

Finally, the Act retains without change the prior-law restriction on tax-exemption for obligations guaranteed or subsidized under Federal, State, or local energy programs, with conforming amendments.

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[48] General obligations of the District of Columbia are not deemed to be directly or indirectly guaranteed by the United States merely because the Department of the Treasury has agreed to pay or guarantee payment of such obligations in the event the courts determine that such obligations are not valid and binding obligations of the District because of the effect of the decision in *INS* v. *Chadha*, 462 U.S. 919 (1983)) on the D.C. home-rule provisions.

4. Other provisions affecting the use of tax-exempt IDBs

Extension of small-issue exception for manufacturing facilities

The Act extends the exception for small-issue IDBs for two years, through December 31, 1988, for bonds issued to finance manufacturing facilities. Therefore, bonds may not be issued under the small-issue exception after December 31, 1986, to finance any nonmanufacturing facility.

The term manufacturing facility generally means any facility that is used in the manufacturing or production of tangible personal property (including processing resulting in a change in the condition of such property).[49] Congress intended that this extension generally not be construed to apply to nonmanufacturing facilities that are associated with manufacturing facilities. For example, the fact that a *de minimis* amount (e.g., less than five percent) of the space in a manufacturing plant is devoted to offices directly related to the manufacturing process conducted in the plant may be disregarded. However, a separate office building in a manufacturing complex or an office wing of a larger, mixed-use, building would be treated as a nonmanufacturing facility.

Restrictions on the use of small-issue IDBs where a beneficiary has significant IDB use

The Act restricts the amount of small-issue IDBs that may be issued for a beneficiary where that person already benefits from a significant amount of such bonds. Under the Act, interest on *small-issue* IDBs is not tax-exempt if the aggregate face amount of *all* tax-exempt IDBs that would be allocated to any beneficiary after issuance of the bonds exceeds $40 million. In determining whether the $40 million limitation has been exceeded, however, bonds that are to be redeemed with the proceeds of the new issue are not considered.

To simplify administration of the $40 million limitation, the Act provides that the face amount of any issue is allocated only among those persons who are test-period beneficiaries. Test-period beneficiaries are defined as owners or principal users of the facilities being financed by the issue at any time during the three-year period beginning on the later of (1) the date such facilities are placed in service, or (2) the date of the issue. No portion of an issue is allocated to persons other than owners and principal users during this three-year test period.

All owners of IDB-financed facilities during the three-year test period are allocated that portion of the issue that is equivalent to the portion of the facilities that they own. All principal users of the facilities during the three-year test period are allocated a portion of the face amount of the issue equivalent to that portion of the facility used by them. Allocations to principal users may be based on square footage used, gross rentals, or any other method prescribed by Treasury Department regulations.

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[49] Bonds, the proceeds of which are to be used to finance agricultural land, are not bonds used for manufacturing facilities within the meaning of this provision.

In determining whether a portion of an issue is allocated to a beneficiary, the related person rules (sec. 103(b)(6)(C)) generally applicable to small-issue IDBs apply. For example, family members (within the meaning of sec. 267) are treated as one person for purposes of determining whether they are principal users of a facility.

Once a portion of an issue is allocated to a test-period beneficiary, that allocation remains in effect as long as the bonds are outstanding. This is true even if the person no longer owns or uses the facilities financed by the bonds. Similarly, the fact that persons are no longer related persons (within the meaning of sec. 103(b)(6)(C)) after any determination under the $40 million limitation is made does not alter previous allocations to that person as long as the bonds are outstanding.

In many cases, these allocation rules will result in all or part of an issue being allocated to more than one person (i.e., in an allocation in excess of 100 percent of the bond face amount). This will occur, for example, when one person owns a facility and other persons are principal users. Further, there may be multiple owners and/or principal users of a facility during the test period. In such a case, all such owners and principal users are treated as test-period beneficiaries and are allocated appropriate portions of the face amount of the bonds, without regard to allocations to prior or subsequent owners or principal users. As stated above, these allocations remain effective until the bonds are no longer outstanding.

The face amount of an issue allocated to any beneficiary for purposes of this restriction includes bonds issued before January 1, 1984 (the effective date of the restriction), if such bonds are outstanding on that date, as well as bonds issued after 1983. Beneficiaries of IDBs, therefore, must determine the face amount of such bonds allocated to them as of January 1, 1984, in order to determine if future issues from which they benefit are tax-exempt.

When a small issue of IDBs becomes taxable as a result of the $40 million limitation, only the issue that causes the restriction to be exceeded is taxable; the tax-exemption of interest on any other, previously issued, IDBs is not affected. However, if the $40 million limitation is violated with respect to an issue by a change of owners or principal users of bond-financed facilities at any time during the three-year test period, the interest on that issue is taxable from the date the bonds were issued.[50]

Restrictions on use of IDBs for purchase of land or existing facilities

Nonagricultural land

Under the Act, interest on IDBs is taxable if more than 25 percent of the proceeds of the issue of which the IDBs are a part is used to finance the acquisition of land (including any interest in land). This 25-percent restriction is increased to 50 percent in the case of bonds issued to finance an industrial park (sec. 103(b)(5)).

[50] This result is distinguished from the result under the $10 million capital expenditure limitation for small-issue IDBs, in which case the Code specifies that denial of tax-exemption is prospective from the date the rule is violated (sec. 103(b)(6)(G).

This provision applies both to exempt-activity and to small-issue IDBs.

The terms of the bond indenture generally will govern in determining which proceeds are allocable to the purchase of land. If the indenture makes no provision for this allocation, the proceeds will be deemed to have been used for the purchase of land and other facilities in relation to the relative fair market values of the properties involved. Congress, intended that, in applying this restriction, expenditures nominally related to land, but that are eligible for cost recovery deductions (e.g., irrigation ditches) are to be treated as made for property other than land.

An exception to the land acquisition rules is provided for land acquired by a public agency in connection with an airport, mass transit, or port development project (as described in sec. 103(b)(4)(D)) if the land is acquired for a bona fide noise abatement, wetland preservation, future use, or other public purpose, and there is no other significant use of the land before the expansion occurs.

Existing facilities

The Act generally prohibits the use of any IDB proceeds to acquire existing facilities (or any interest therein). As with the restriction on the acquisition of land, this restriction applies both in the case of exempt-activity and small-issue IDBs. The Act includes an exception, however, permitting the acquisition of an existing building (and equipment for such building) if expenditures are made for rehabilitation in an amount exceeding 15 percent of the lesser of (1) the purchase price of the building and related equipment, or (2) the amount of bonds issued for acquisition of the building (and related equipment). This exception also applies to other structures (e.g., dry docks), but in such cases, the rehabilitation expenditures must exceed 100 percent of the lesser of cost or bonds issued.

Qualified rehabilitation expenditures, for purposes of these restrictions, generally include any amount properly chargeable to capital account that is incurred by the person acquiring the building or other qualifying structure in connection with the rehabilitation project. For example, if IDBs were used to purchase a building for $500,000[51] and existing equipment in the building for $250,000, interest on the bonds would be tax-exempt if rehabilitation expenditures of at least $112,500 (i.e., 15 percent of $750,000) were made.

A rehabilitation project includes the building or other real property structure, equipment located in the building or structure, and other functionally related and subordinate improvements that form part of a project, as that term is defined for purposes of the rules governing issuance of IDBs to finance residential rental property (sec. 103(b)(4)(A)). In the case of an integrated operation contained in a building before its acquisition, rehabilitation expenditures also include the expenses of rehabilitating existing equipment previously used to perform the same function in a building or replacing the existing equipment with equipment having substantially the same function. The rule regarding integrated operations is not applicable

[51] For purposes of this example, the cost of land on which a building is located is not taken into account.

to replacement equipment that does not have substantially the same function as the equipment being replaced. Additionally, no rehabilitation of equipment that is not part of an integrated operation will be treated as a rehabilitation expenditure.

These restrictions on acquisition of equipment apply only in the case of used equipment. New equipment generally may be acquired without regard to this restriction, provided the other appropriate restrictions of the Code are satisfied. Costs of new equipment are treated as rehabilitation costs, however, only in cases where the new equipment replaces the equipment having substantially the same function.

As is true under the rules governing projects of residential rental property, expenditures for building fixtures (e.g., stoves, refrigerators, and carpeting) are to be treated as expenditures for rehabilitation of the building itself. Similarly, expenditures for rehabilitation of parking lots, garages, or swimming pools, are included to the extent that the rehabilitated facilities are part of a project (*see*, e.g., sec. 103(b)(4)(A)). Rehabilitation expenditures specifically exclude certain expenditures that are excluded from the definition of qualified rehabilitation expenditures for purposes of the rehabilitation tax credit (including costs of acquisition and enlargements), expenditures of lessees having a remaining lease term of less than 18 years (15 years for certain low-income housing), and expenditures allocable to tax-exempt use property (sec. 48(g)(2)(B)).

Rehabilitation expenses generally must be incurred by the person acquiring the building or other qualifying structure. Under a special rule, however, amounts incurred by a successor in interest to the person acquiring the building or structure, or by the seller under a sales contract with the acquiring person, are to be treated as incurred by the acquiring person. Additionally, only those expenditures incurred before the date that is two years after the date the building is acquired, or (if later) the date the bonds are issued, are to be treated as rehabilitation expenditures.[52]

Congress anticipated that Treasury Department regulations may provide appropriate *de minimis* exceptions to the definition of existing facilities for purposes of these restrictions. For example, these regulations could provide that property generally will not be treated as an existing facility if only a small portion of the taxpayer's adjusted basis in the property is attributable to components previously used by another taxpayer (*see* Treas. Reg. sec. 1.48-2(b)(1)).

In addition to nonagricultural existing facilities, tax-exempt IDB proceeds may be used to acquire existing agricultural buildings and structures (other than land) if the appropriate rehabilitation requirement is satisfied. Unlike agricultural land, discussed below, use of this tax-exempt financing is not restricted to first-time farmers, who are the only persons eligible for such financing for farmland.

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[52] In cases where a purchaser is treated as incurring expenses of the seller of a facility or incurs such expenses himself before acquisition of a facility, the purchaser is treated as having acquired the facility at the time the expenditures are made for purposes of this two-year limitation.

First-time farmer exception

Under the Act, the acquisition of land used for agricultural purposes may be financed with tax-exempt bonds only if the person acquiring the land is a first-time farmer. Under this exception, each first-time farmer also is limited to $250,000 of IDB financing for agricultural land. Certain facilities located on, or used in connection with, farmland also may qualify for tax-exempt financing under this exception. The general 25-percent restriction on the use of tax-exempt bond proceeds to finance acquisition of land does not apply in this case. For example, the entire proceeds of an issue of $250,000 or less may be used by a first-time farmer to acquire agricultural land.

A first-time farmer is defined as an individual who has not at any time had any direct or indirect ownership in substantial land (defined below) used for farming purposes in a farming operation in which the individual or the individual's spouse or dependent children have materially participated. The individual also must be the primary user of the land, and must participate materially and substantially *on the farm* in the farming operation of which the property is to be a part. Corporations, partnerships, and other entities may not acquire farmland under this exception.

As stated above, first-time farmers may not have had any ownership interest in substantial farmland at any time. Substantial farmland includes any parcel of land that is greater than 15 percent of the median size of a farm in the county in which the land is located or the fair market value of which exceeds $125,000 at any time when the land is held by the individual in question. For purposes of this restriction, a leasehold interest is not treated as an ownership interest. Additionally, ownership of certain structures located on land that the individual does not own (e.g., sheds to house equipment used in a farming operation on leased land) is not considered.

The Act further provides that a *de minimis* portion of IDB financing provided to first-time farmers may be used for acquisition of used equipment to be used in the farming operation conducted on the land purchased with the balance of the IDB proceeds.[53] Only equipment acquired with the IDB proceeds and within one year after acquisition of the farmland is eligible for IDB financing under this *de minimis* exception. Additionally, the *de minimis* exception is to be determined with respect to each individual borrower and not on an issue-by-issue basis.

Denial of tax-exempt IDB financing for certain facilities

The Act provides that interest on IDBs is not tax-exempt if any portion of the proceeds of an issue is to be used to finance any airplane, skybox or other private luxury box, 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

[53] For purposes of the first-time farmer exception, purchase of a *de minimis* amount of equipment is treated as the purchase of additional farmland. The acquisition of new equipment to be used in farming may, in certain cases, be financed with IDBs other than by virtue of this exception.

off-premises. This prohibition applies both to exempt-activity IDBs and to small-issue IDBs.

Under a special rule, the use of IDBs to finance the construction, renovation or refurbishing of a facility will not be prohibited solely because skyboxes are included in the project, as long as the project otherwise qualifies for tax-exempt financing. Rather, no portion of the proceeds of the issue may be used to provide any skybox. For purposes of this special rule, the skybox is deemed to include the interior furnishing of the box (e.g., the box's plumbing, electrical and decorating costs) and the structural components required for the box (e.g., the box's walls, ceilings, special enclosures), but not the normal components of the stadium, such as structural supports, to the extent these components would have been required for the remaining portion of the stadium if no skyboxes (and no regular seats in lieu of skyboxes) had been built.

Application of small-issue IDB limits to entire project

The Act provides a special rule to prevent avoidance of the limitations on small-issue IDBs by dividing the ownership of a project among several persons. Under the rule, where two or more issues of IDBs are used to finance a single building, an enclosed shopping mall, or a strip of offices, stores, or warehouses that use substantial common facilities, the two or more issues are treated as a single issue for purposes of determining qualification under the small-issue exception, and all principal users of any of the facilities financed with the bonds are treated as principal users of a single facility. Thus, under the rule, where ownership of a project is divided among several different unrelated users, qualification under the small-issue exception is to be determined by measuring the capital expenditures and outstanding obligations of all the principal users of that project.

Examples of common facilities include (1) common heating and cooling facilities, or (2) common entrances, plazas, malls, lobbies, parking, elevators, or stairways for use by employees or patrons of the facilities. To be common facilities, the two facilities used by the different users generally must be contiguous. For example, all units in a strip shopping center that use a common parking lot are treated as a single facility (regardless of whether the strip shopping center is divided physically into more than one structure) because the structures essentially are contiguous to each other. However, two or more stores located in a downtown redevelopment project that are not contiguous to each other and do not use common facilities generally are not treated as a single project. Structures that are separated by inconsequential barriers, such as rights of way, are treated as contiguous for this purpose.

Congress intended that the Treasury Department will issue regulations delineating circumstances in which, because use of common facilities is *de minimis*, otherwise separate facilities will not be treated as a single project. For example, separate department stores that each lease less than 25 percent of an independently owned parking garage adjoining the stores are not to be treated as a single facility. Likewise, use of utility facilities, such as the same local district heating and cooling system, by otherwise separate businesses, is not in itself sufficient to treat the buildings used by the businesses as a single project.

Extension of substantial user rule to all partners in a partnership and to all shareholders in an S corporation

The Act amends the prior-law rules under which interest on IDBs is not tax-exempt to the extent that the bonds are owned by a substantial user of the facilities financed with the IDB or the holder is a related person to a substantial user. Under the amended provision, all partners (including both general and limited partners) of a partnership, together with their spouses and minor children are treated as related persons to the partnership. Additionally, an S corporation and each of its shareholders, together with their spouses and minor children, are treated as related persons. For example, interest on an issue of IDBs owned by any partner of a partnership that is a substantial user of the facilities financed with the IDBs (or by an S shareholder where the corporation is a substantial user) is not tax-exempt.

Clarification that residential rental property may be in a mixed-use structure

The Act clarifies prior law to provide that facilities may be treated as residential rental property for low -or moderate-income individuals for purposes of the Code (sec. 103(b)(4)(A)), even though not all of the building is used for residential rental use. Thus, for example, a building may qualify as residential rental property even though all or a portion of the bottom floor is used for commercial use. However, in such a case, no more than an insubstantial portion of the tax-exempt financing may be used to finance any portion of the building not actually used as residential rental property.

Congress intended that, in determining the portion of the property qualified for tax-exempt financing, the cost of property that benefits both uses must be allocated between those uses. For example, where a portion of a building is used for commercial purposes and another portion of that building is used for residential rental purposes, a portion of the cost of the building's foundation and other common elements must be allocated to the commercial use, with only the balance being allocated to the residential rental use.

Repeal of advance refunding for qualified public facilities

The Act repeals the prior-law provision permitting advance refunding of IDBs, the proceeds of which are used to finance convention and trade show facilities (sec. 103(b)(4)(C)) and airports, docks, wharves, mass commuting facilities, parking facilities (and storage and training facilities related thereto) (sec. 103(b)(4)(D)).

5. Additional arbitrage restrictions for IDBs

In general

The Act extends arbitrage restrictions similar to those previously applied to qualified mortgage bonds to most IDBs issued after December 31, 1984. These arbitrage restrictions are in addition to the rules that applied to such bonds under prior law.

Requirement of rebate of certain arbitrage profits

General rules

Under the Act, certain arbitrage profits earned on nonpurpose obligations acquired with the gross proceeds of IDBs must be rebated to the United States. Nonpurpose obligations generally include all obligations other than those specifically acquired to carry out the governmental purpose for which the bonds are issued. For purposes of these restrictions, obligations invested in a debt service reserve fund are considered to be nonpurpose obligations. Congress intended that the term gross proceeds be interpreted broadly. Gross proceeds are the total proceeds of an issue, including the original proceeds of the bonds, the investment return on obligations acquired with the bond proceeds (including repayment of principal), and amounts used or available to pay debt service on the issue.

Arbitrage profits that must be rebated include (1) the excess of the aggregate amount earned on all nonpurpose obligations (other than income earned on the arbitrage itself) over the amount that would have been earned if all nonpurpose obligations were invested at a rate equal to the yield on the issue, plus (2) any income earned on the arbitrage. The yield on an issue is determined based on the issue price, taking into account the Code rules on original issue discount and discounts on debt instruments issued for property (secs. 1273 and 1274).

In determining the amount of arbitrage profits, *no* costs associated with the nonpurpose obligations or the bond issue itself are considered. Therefore, the determination is made without regard to issuance costs and underwriter's discount. Additionally, gain or loss realized on the disposition of any nonpurpose obligations at fair market value is included in determining the aggregate amount earned on such obligations. The deflection of arbitrage through the purchase or sale of nonpurpose obligations at other than fair market value is prohibited.

Ninety percent of the rebate required with respect to any issue must be paid at least once each five years, with the balance being due 30 days after retirement of the issue. Congress was aware that there may be rebatable arbitrage profits with respect to a particular issue during one five-year period followed by a negative arbitrage posture during the next five year period, or *vice versa*. The requirement that only 90 percent of the arbitrage profits be rebated each five years with a final "settling up" after retirement of the bonds reflects Congress' understanding that exact determinations might not be possible during the period that the bonds are outstanding. Therefore, subsequent payments will reflect overpayments or underpayments during previous periods.

Conforming amendments are made to provide that the amount subject to rebate is not taxable and that the rebated amount is not deductible for Federal income tax purposes.

Exceptions to requirement of rebate

The rebate requirement does not apply to an issue if all gross proceeds of the issue are expended within six months of the issue date and for the governmental purpose for which the bonds are issued.

A second exception is provided for certain temporary investments related to debt service. Under this exception, if less than $100,000 is earned on a bona fide debt service fund in a bond year with respect to an issue, arbitrage earned on the fund in that year is not subject to the rebate requirement, unless the issuer elects to consider such amounts when determining if a rebate otherwise is due with respect to the issue. This election must be made at the time of, or before, issuance of the bonds, and the election, once made, is irrevocable.

Restriction on investment in nonpurpose obligations

In addition to the rebate requirement, the Act restricts the amount of bond proceeds that may be invested in nonpurpose obligations at a yield above the bond yield at any time during a bond year to 150 percent of the debt service for the bond year. These investments must be reduced as the bond issue is repaid. This restriction does not apply to amounts invested for the initial temporary periods permitted under both prior and present law and for temporary periods related to debt service. (The rebate requirement will apply, however, to such amounts if the gross proceeds are not expended for the governmental purpose within six months.)

For purposes of this restriction, debt service includes interest and amortization of principal scheduled to be paid with respect to an issue for the bond year, but does not include payments with respect to bonds that are retired before the beginning of the bond year. This restriction does not, however, require the sale or other disposition of any investment if that disposition would result in a loss that exceeds the amount that otherwise would be paid to the United States assuming a payment was due at that time.

General exception to additional arbitrage restrictions

The additional arbitrage restrictions imposed by the Act do not apply to any obligation the proceeds of which are to be used to finance residential rental property (sec. 103(b)(4)(A)), including any housing program obligation issued under section 11(b) of the Housing Act of 1937. However, the arbitrage restrictions applicable to tax-exempt bonds generally, including IDBs, do apply to these obligations.

6. Extension of Internal Revenue Code rules to certain obligations

General rules

The Act extends certain Internal Revenue Code requirements relating to tax-exempt obligations to bonds for which tax-exemption was provided in the past by existing provisions of Federal law other than the Code and bonds that otherwise were deemed to satisfy Code requirements by such provisions of law. The requirements extended to these obligations generally are (1) the rules relating to industrial development bonds, arbitrage bonds, and mortgage subsidy bonds; (2) the public approval requirements and information reporting requirements; (3) the requirement that the obligations be in registered form;[54] (4) the disallowance of tax-exemption for obligations that are Federally guaranteed; and (5) the overall State volume limitation applicable to private-activity bonds. In the case of obligations issued by U.S. possessions (including Puerto Rico, the Virgin Islands and Guam), the overall volume limitations are to be applied as if those possessions were States, except that the $200 million safe harbor limitation does not apply (i.e., the possessions are limited to a $150 per capita volume limitation).

The specific Code provisions that apply to each type of non-Code bond depends on the characteristics of the bond. For example, all of the prescribed requirements will apply to bonds that, in substance, are industrial development bonds (as defined in sec. 103(b)). If a bond is not within the definition of an IDB, however, only those Code requirements applicable to bonds other than IDBs must be satisfied (e.g., the arbitrage rules of sec. 103(c), other than subsection (c)(6)). Under this provision, for example, interest on the obligations issued after January 1, 1984, described in existing non-Code provisions is not exempt from Federal income tax unless the obligations comply with the rules described above.

Exceptions

Obligations issued pursuant to the Northwest Power Act (16 U.S.C. 839d), as in effect on July 18, 1984 (i.e., obligations of the Bonneville Power Administration) are exempt from this provision. Obligations issued pursuant to sec. 608(6)(A) of P.L. 97-468 also are exempt from these requirements. Finally, public housing program obligations issued before June 19, 1984,[55] pursuant to the Housing Act of 1937 are not subject to the Code requirements.

7. Limitations on consumer loan bonds

General rule

The Act provides that interest on consumer loan bonds is not tax-exempt. Additionally, authority to issue tax-exempt bonds which authority is enacted after July 18, 1984, must be enacted as part of a revenue act. The Act defines consumer loan bonds as obligations that are part of an issue of which five percent or more of the proceeds is to be used, directly or indirectly, to make or finance loans to persons other than exempt persons.[56] For this purpose, permitted investments of bond proceeds unrelated to the purpose of the bond issue under the additional arbitrage restrictions imposed by the Act are disregarded. Congress intended that, under this restriction, substance govern over form in determining what is a loan.

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[54] It is anticipated that a technical amendment will be recommended clarifying that the requirements of section 103(j) apply to these bonds in appropriate circumstances.

[55] In letters to Senator Dole and Mr. Rostenkowski, dated November 6, 1984, the Internal Revenue Service stated that it will make available administrative relief to certain issues of these bonds issued after June 18, 1984, and before August 2, 1984, that may not satisfy appropriate Code requirements. These issues were issued on July 3, 1984, and on August 1, 1984, at which time the Department of Housing and Urban Development may have been unaware of the requirement that the bonds satisfy Code requirements. The letters further indicated that similar administrative relief will be made available to certain urban renewal notes issued after December 31, 1983, and before August 2, 1984.

[56] For purposes of this restriction, the term exempt person generally has the meaning given that term in Code section 103(b)(3).

Loans to enable a borrower to finance any tax or governmental assessment of general application for an essential government function are not taken into account. For example, bonds to finance mandatory municipal water and sewer installation assessments that a local government permits residents of the jurisdiction generally to pay over a period of years are not treated as consumer loan bonds. On the other hand, bonds to finance loans that are available to the public generally, but are not used to finance a governmentally mandated activity would be consumer loan bonds. An example of such prohibited loans would be a program under which loans financed with bond proceeds are available to persons owning property adjacent to a shoreline for the purpose of building discretionary breakwaters.

Exceptions

The Act includes exceptions to this restriction for obligations with respect to which Congress has authorized tax-exemption in the past. Thus, exceptions are provided for IDBs, for qualified mortgage bonds and qualified veterans' mortgage bonds, and for qualified student loan bonds.

Qualified student loan bonds are defined as obligations that are part of an issue all or a major portion of the proceeds of which reasonably is expected to be used, directly or indirectly, to finance loans to students. This exception is limited to loans made under a program which is of general application and with respect to which special allowance payments (SAP payments) under the Higher Education Act of 1965 are authorized.[57] Additionally, this exception applies only if (1) the program restricts the maximum amount of loans that may be outstanding to any student and the maximum rate of interest payable on any loan, and (2) the loans are guaranteed by the Federal Government. Qualified student loan bonds do not include obligations issued under a State program that discriminates on the basis of the location (in the United States) of any educational institution attended by borrowers (e.g., a program that provides loans only for students attending in-state institutions).

Congress intended that qualified student loan bonds generally include only bonds issued in connection with the Guaranted Student Loan (GSL) and PLUS programs of the Federal Government. Under the Act, interest on student loan bonds other than qualified student loan bonds ("nonqualified student loan bonds") issued after July 18, 1984, generally is not tax-exempt. Limited exceptions are provided for specified State programs; these exceptions further are limited to specified amounts of tax-exempt obligations.

The Act also includes an exception for student loan bonds exclusively used to refund obligations issued before March 15, 1984, provided that the amount of the refunding bonds does not exceed 101 percent of the aggregate face amount of the refunded obligations, and the maturity date of any refunding obligation is not more than 17 years after the date on which the refunded obligation was issued

[57]If SAP payments would be authorized for any particular loans but for the fact that the loans are not financed with the proceeds of tax-exempt bonds, such payments are deemed to be authorized for purposes of determining whether a program as a whole is a program making qualified student loans.

(or, in the case of a series of refundings, the date on which the original obligation was issued).

A further exception from the consumer loan bond restrictions is provided for the Texas Veterans' Land Bond Program, a program that had continuously been in effect in substantially the same form for 30 years before the date of enactment. This exception is limited to obligations used to make loans (or to fund similar obligations) (1) in the same manner, (2) in the same (or a lesser) amount per participant, and (3) for the same purposes as the program in operation on March 15, 1984. The exception further is limited to obligations issued before March 15, 1987.

Finally, an exception is provided for certain bonds that received transitional exceptions under the Mortgage Subsidy Bond Tax Act of 1980 and for bonds for renewable energy property described in section 243 of the Crude Oil Windfall Profit Tax of 1980.

Effective Dates

Private activity bond volume limitation

The overall State volume limitation for certain private activity bonds is effective for obligations (other than refunding obligations)[58] issued after December 31, 1983. A general exception is provided for obligations with respect to which an inducement resolution was adopted before June 19, 1984, if the bonds are issued on or before December 31, 1984. If a jurisdiction does not adopt inducement resolutions generally for the type of obligation concerned, a comparable preliminary approval must have been adopted before June 19, 1984.

Congress intended that generally only the party for whom an inducement resolution (or other comparable preliminary approval, as defined above) was adopted originally is entitled to claim the benefits of this transition rule. However, in a case where additional co-owners acquire an interest in a project after adoption of an inducement resolution, the exception is to be available, but only if (1) the original party for whom the resolution was adopted retains at least a 50 percent undivided interest in the project, (2) the bonds are issued pursuant to the original inducement resolution, and (3) the total amount of bonds issued for all parties with an undivided interest in the project does not exceed the amount provided in the inducement resolution.

The Act also includes a special rule under which obligations for financing certain projects are granted priority under the State volume limitation. Obligations with respect to which an inducement resolution (or other comparable preliminary approval) was adopted by any issuing authority before October 19, 1983, and with respect to projects for which either (1) the original use of which commenced with the taxpayer and the construction of the financed facilities had commenced before October 19, 1983, or (2) a substantial user of the facility was under a binding contract on October 19, 1983, (and at all times thereafter) to incur significant expenditures with respect to the facility, will receive priority of allocation for 1985 and later years.

[58] Advance refunding obligations are subject to the overall State volume limitation.

Sponsors of such projects were allowed 30 days from the date of enactment (i.e., until August 17, 1984) to notify an issuing authority of their intention to exercise their priority claim. The Act defines significant expenditures to mean expenditures equal to or exceeding the lesser of $15 million or 20 percent of the estimated cost of the facilities.

Whether or not an arrangement constitutes a contract is to be determined under the applicable local law. A binding contract is not considered to have existed on October 19, 1983, however, unless the property to be acquired or services to be rendered were specifically identified or described before that date.

A binding contract for purposes of this provision exists only with respect to property or services for which the taxpayer is obligated to pay under the contract. In addition, where a contract obligates a taxpayer to purchase a specified number of articles and also grants an option to purchase additional articles, the contract is binding only to the extent of the articles that must be purchased.

A contract may be considered binding on a person even though (a) the price of the article to be acquired or the services to be rendered under the contract is to be determined at a later date, (b) the contract contains conditions the occurrence of which are under the control of a person not a party to the contract, or (c) the person has the right under the contract to make minor modifications as to the details of the subject matter of the contract.

A contract that was binding on October 19, 1983, will not be considered binding at all times thereafter if it is modified substantially after that date. Additionally, a contract under which a person had an option to acquire property is not a contract that is binding on the taxpayer for purposes of this exception unless the amount paid for the option is forfeitable and is more than a nominal amount.

All property that is part of facilities described in an inducement resolution (or other comparable preliminary approval) adopted before October 19, 1983, pursuant to which the bonds are issued, is to be treated as under construction by October 19, 1983, where any part of those facilities was under construction before October 19, 1983. Moreover, all such property is included under this transition rule even though part of the facilities are transferred by the taxpayer before being placed in service and even though property that is part of the facilities is placed in service before completion of construction of other properties that are part of those facilities.

If, upon request, the governmental unit granting a pre-October 19, 1983, inducement resolution does not provide priority over other projects, the authority of that governmental unit to issue private activity bonds is reduced in the next subsequent calendar year. Where there were more projects entitled to receive priority than that governmental unit has authority to finance, priority is required to be granted first to those projects for which substantial expenditures were incurred before October 19, 1983. A governmental unit may not avoid this rule by transferring all or a part of its authority to another governmental unit. However, the priority rule may be overridden by a specific State statute.

The Act also provides specific exemptions for a certain convention center and resource recovery facility located in Philadelphia, Pennsylvania.

Restrictions on cost recovery deductions for property financed with IDBs

The provision restricting cost recovery deductions of property financed with IDBs generally applies to property placed in service after December 31, 1983, to the extent that such property is financed by the proceeds of IDBs issued after October 18, 1983.

However, the restrictions on cost recovery deductions do not apply to facilities placed in service after December 31, 1983, if —

(1) the original use of the facilities commence with the taxpayer and the construction of the facilities had commenced before October 19, 1983, or

(2) a binding contract existed before October 19, 1983, and at all times thereafter which committed the purchaser to incur significant expenditures for construction or acquisition of the facilities.

For purposes of this restriction, the determination of whether expenditures are significant and whether a binding contract existed before October 19, 1983, is made in the same manner as under the rules governing the overall State volume limitation.

The restrictions on cost recovery deductions also do not apply to property placed in service after December 31, 1983, to the extent that property is financed with tax-exempt bonds issued before October 19, 1983. For purposes of this exception, a refunding issue issued after October 18, 1983, generally is treated as a new issue and the taxpayer must use the slower recovery methods for costs that are unrecovered on the date of the refunding issue.

In cases where a change of recovery method is required because of a refunding issue, only the remaining unrecovered cost of the property is required to be recovered using the slower method and period. Therefore, no retroactive adjustments to cost recovery deductions previously claimed are required upon a refinancing of a pre-October 19, 1983 issue where no significant expenditures are made with respect to the facility after December 31, 1983.

Other provisions

Individual effective dates are established for the other provisions of the Act affecting tax-exempt obligations. Exceptions are provided to many of these effective dates for obligations where (1) an inducement resolution or other comparable preliminary approval was adopted before a specified date, or (2) the original use of the facility commences with the taxpayer and its construction began before a specified date, or (3) significant expenditures were incurred or a binding contract existed before a specified date. For purposes of these exceptions, the determination of whether an inducement resolution (or other comparable preliminary approval) was adopted, of whether a taxpayer was the original user or construction had commenced before a specified date, of whether significant expenditures were made, or of whether a binding contract existed is made in the same manner as that used under rules on the State volume limitation.

Denial of tax-exemption for obligations issued with a Federal guarantee

The restrictions on Federal guarantees of tax-exempt obligations apply generally to obligations issued after December 31, 1983.

These restrictions do not apply to obligations, however, if the proceeds of the obligations are to be used for a facility the original use of which commences with the taxpayer and the construction, reconstruction, or rehabilitation of which began before October 19, 1983, or if a binding contract to incur significant expenditures with respect to the facility was entered into before October 19, 1983, and was binding at all times thereafter.

Additionally, under a special effective date provision, the portion of this provision denying tax-exemption to interest on obligations that are Federally guaranteed in conjunction with Federally insured deposits or accounts in financial institutions applies to obligations issued after April 14, 1983, except for obligations issued pursuant to a written commitment binding on March 4, 1983, and at all times thereafter.

Extension of small-issue exception

The extension of the small-issue exception (limited to obligations to finance manufacturing facilities) applies to obligations issued after December 31, 1986, and before January 1, 1989.

Restrictions on the use of small-issue IDBs where a beneficiary has significant IDB use

The rules limiting the aggregate volume of bonds of which a person may be a beneficiary apply generally to obligations issued after December 31, 1983. Two exceptions to this restriction are provided by the Act. First, the restriction does not apply to obligations the proceeds of which are to be used to finance a facility the original use of which commences with the taxpayer and the construction, reconstruction, or rehabilitation of which began before October 19, 1983, or with respect to which a binding contract to incur significant expenditures was entered into before October 19, 1983, and was binding at all times thereafter.

Second, this restriction does not apply to obligations for which an inducement resolution (or other comparable preliminary approval) was adopted before June 19, 1984, if the obligations are issued before January 1, 1985.

Restrictions on use of IDBs for purchase of land, existing facilities, and for certain other specified facilities

The restrictions on the use of tax-exempt financing for land (both agricultural land and nonagricultural land), for existing facilities, and for certain other specified facilities (other than race tracks and health clubs) apply to obligations issued after December 31, 1983. The Act provides a general exception and several specific exceptions to these restrictions. The general exception provides that the restrictions do not apply to obligations the proceeds of which are to be used to finance a facility the original use of which commences with the taxpayer and the construction, reconstruction, or rehabilitation of which began before October 19, 1983, or with respect to which a binding contract to incur significant expenditures was entered into before October 19, 1983, and was binding at all times thereafter.

The restrictions on financing land (other than land used for agricultural purposes) and existing facilities also do not apply to obligations for which an inducement resolution (or other comparable preliminary approval) was adopted before June 19, 1984, if those obligations are issued before January 1, 1985.

The restriction on using tax-exempt bond proceeds to finance gambling facilities does not apply to obligations issued to finance race tracks if an inducement resolution (or other comparable preliminary approval) was adopted with respect to the race track before June 19, 1984, and those obligations are issued before January 1, 1985.

The restriction on using tax-exempt bond proceeds to finance health clubs applies to obligations issued after April 12, 1984.[59] A special exception to this effective date is provided pursuant to which interest on obligations issued after April 12, 1984, to finance a health club facility may be tax-exempt if the original use of the facility begins with the taxpayer and the construction, reconstruction, or rehabilitation of the facility began before April 13, 1984, or if a binding contract to incur significant expenditures with respect to the facility was entered into before April 13, 1984, and was binding at all times thereafter.

Other rules

The provisions on aggregation of small-issue IDBs, on bonds used to finance residential rental property in a mixed-use structure, and on ownership of bonds by substantial users of the bond-financed facilities apply generally to obligations issued after December 31, 1983.[60] A general exception provides that these rules do not apply to obligations the proceeds of which are to be used to finance a facility the original of which commences with the taxpayer and the construction, reconstruction, or rehabilitation of which began before October 19, 1983, or obligations issued for a facility where a binding contract to incur significant expenditures existed before that date, and at all times thereafter.

Repeal of advance refunding for certain facilities

The repeal of the prior-law rule permitting advance refunding of obligations issued to finance certain facilities applies to refunding obligations issued after July 18, 1984. An exception permits advance refunding of obligations substantially all of the proceeds of which were used to provide airports or docks if the refunding obligations are issued before January 1, 1985. An additional exception is provided for certain advance refunding obligations of the Alabama State Docks Department and the Dade County Airport if those obligations are issued before January 1, 1986.

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[59]The Act inadvertently omitted this special effective date and the exception thereto. It is anticipated that a technical amendment will be recommended to clarify the correct effective date for this provision.

[60]Congress understood that the Treasury Department viewed the amendment to the rules on residential rental property in a mixed-use structure as a technical clarification of prior-law, and intends to review its regulations that provide a different result.

Additional arbitrage restrictions

The additional arbitrage restrictions imposed with respect to IDBs apply to obligations issued after December 31, 1984. An exception to this provision is provided for certain obligations issued by the Essex County Port Authority of New York and New Jersey.

Extension of Code requirements to certain obligations

The provision extending the requirements of the Internal Revenue Code to bonds for which tax-exemption previously was provided other than in the Code applies generally to obligations issued after December 31, 1983.

Consumer loan bond provisions

The restriction on issuance of consumer loan bonds applies generally to obligations issued after July 18, 1984.

Exceptions for specifically described facilities

The Act also includes exceptions from some or all of the private activity bond provisions for specifically described projects. Generally, these exceptions apply only with respect to individual facilities or projects.

Revenue Effect

The provisions of Parts B and C, and D (as therein noted) are estimated to have the following effect on fiscal year budget receipts: a reduction of $24 million in 1984 and increases thereafter of $5 million in 1985, $209 million in 1986, $396 million in 1987, $397 million in 1988, and $386 million in 1989.

C. Additional Provisions Affecting Student Loan Bonds

(Secs. 625 and 646 of the Act and sec. 103 of the Code)

Prior Law

Tax-exempt student loan bonds

Under prior law, tax-exempt bonds could be issued to finance personal loans to individuals for nonbusiness purposes, including the financing of student loans. Because the proceeds of such loans generally were not used in the conduct of a trade or business, these bonds were not subject to the restrictions applicable to industrial development bonds. However, prior law did contain a number of restrictions on the use of tax-exempt bonds to provide financing for owner-occupied residences (sec. 103A).

Department of Education subsidies

The Department of Education subsidizes student loans under the Guaranteed Student Loan (GSL) and PLUS programs. The subsidy takes three forms. First, the Department of Education guarantees repayment of qualified student loans. Second, the Department pays special allowance payments (SAPs) as an interest subsidy on qualifying student loans so that the student borrowers are required to pay less interest on the loans. If student loans are financed with tax-exempt bonds, the amount of these SAPs is reduced. Third, the Education Department pays an additional interest subsidy on qualified loans while the student is attending school. These Federally subsidized loans, in turn, may be financed with tax-exempt bonds.

Section 7 of the Student Loan Consolidation and Technical Amendments Act of 1983 requires issuers of tax-exempt bonds, as a condition to receiving SAP payments, to issue no more tax-exempt bonds than are required to finance the reasonable needs for student loan credit within the area served by the authority, after taking into account existing sources of student loan credit in the area. The Department of Education issued proposed regulations under this provision on February 10, 1984 (49 *Fed. Reg.* 5330). These regulations generally would require that an authority conduct a survey of available credit (including funds available for loans on which the interest would be taxable) in the area and conclude that such credit is insufficient to meet reasonable needs before issuing tax-exempt student loan bonds. Additionally, the proposed regulations would restrict the maturity of tax-exempt student loan bond issues to 10 years. Refundings would be limited to the outstanding balance of the loans being financed.

The proposed regulations also would require that proceeds of tax-exempt student loan bond issues be expended within two years (in the case of issues used to acquire existing student loans) or one year (in the case of issues used to make direct loans). Proceeds not so used in excess of five percent of the amount of the original issue (other than proceeds invested in a reasonably required reserve or replacement fund) would have to be used promptly to repay obligations comprising the issue. An authority further would be prohibited from issuing bonds more than three months before the bond-use period commences.

Arbitrage restrictions

Interest on obligations (including qualified scholarship funding bonds) that are arbitrage bonds is not tax-exempt. An arbitrage bond is defined as an obligation that is part of an issue all or a major portion of the proceeds of which are to be used (directly or indirectly) to acquire taxable obligations that produce a materially higher yield than the yield on the tax-exempt obligations (or to replace funds that are so used). There are exceptions for materially higher yielding obligations held for a temporary period or in a reasonably required reserve or replacement fund.

Treasury Department regulations generally limit permissible arbitrage on student loan notes to a spread between the interest on the bonds and the interest paid equal to the greater of (1) 1.5 percentage points plus reasonable administrative costs, or (2) all reasonable direct costs of the loan program (including issuance costs and bad debt losses). For this purpose, the SAP payments made by the Department of Education as an interest subsidy on student loan notes are not treated as interest on notes. As a result, issuers may receive the regularly permitted arbitrage earnings plus the direct interest subsidy. Additional arbitrage rules apply to investments of bond proceeds other than in student loan notes that are acquired with the proceeds of the issue.

Reasons for Change

Congress was concerned about the growing use of tax-exempt bonds to finance loans for personal expenses of higher education (including tuition, fees, books, and personal living expenses) and the possible use of tax-exempt bonds to finance other personal loans.

Currently, the average charges for tuition, fees, and room and board are in excess of $7,000 at private colleges and universities and exceed $3,000 at public institutions. With over 12 million students enrolled in institutions of higher education, Congress was concerned that the volume of tax-exempt bonds might increase substantially if such bonds could be issued without limitation to finance the costs of tuition, room, and board at colleges and universities. If tax-exempt bonds were used to finance an average loan of $4,000 for 12 million students, the annual volume of private activity bonds would increase by $48 billion, an amount that exceeds the total volume of private activity bonds issued in 1982. If tax-exempt bonds were used only to finance an average loan of $6,000 for the approximately 2.5 million students enrolled at private institutions, the increased volume of these bonds would be $15 billion, more than the total amount of small-issue IDBs issued in 1982.

In the area of higher education loans, Congress believed that a moratorium should be imposed on the creation or substantial expansion of existing tax-exempt student loan bond programs (other than the GSL and PLUS programs) so that it will be able to evaluate the costs and benefits of such programs and consider whether Federal standards or limitations should be imposed on such programs.

Congress also was concerned that the existing arbitrage rules for student loan bonds may not be appropriate. In particular, Congress was concerned that changes in the Higher Education Act of 1965 and the Internal Revenue Code, affecting student loan bonds, may be made in the future, without consideration of the interaction between the two statutes.

Congress believed that Department of Education review of the issuance of such bonds is an appropriate step to control unnecessary issuance of these bonds. However, because many of the issues arising in a determination of whether and how many tax-exempt bonds should be issued to finance student loans are issues within the sole purview of the Department of the Treasury, Congress determined that the Department should be granted the authority to review any determinations of the Department of Education on this subject.

Finally, Congress believed that issuers of student loan bonds under the GSL and PLUS programs should be encouraged to issue taxable bonds where taxable financing, together with the higher SAP authorized by Higher Education Act of 1965, can serve the reasonable needs for student loan credit within the area served by the issuer.

Explanation of Provisions

Restriction of tax-exemption to qualified student loan bonds

The Act continues the prior-law rule under which interest on student loan bonds issued in connection with the Guaranteed Student Loan and PLUS programs of the Department of Education (qualified student loan bonds) is tax-exempt. The Act provides, however, that interest on other student loan bonds generally is taxable. As discussed in Part B, under the explanation of the consumer loan bond provisions, exceptions are provided allowing certain established State programs to issue limited amounts of these other student loan bonds, notwithstanding these restrictions and the restrictions on issuance of consumer loan bonds.

Arbitrage restrictions

Qualified student loan bonds

Under the Act, qualified student loan bonds will continue to be subject to the arbitrage restrictions previously applicable to such bonds for an interim period. The Act establishes a procedure for review of these restrictions and imposition of new arbitrage restrictions on these bonds.

The Congressional Budget Office and the General Accounting Office are directed to study and report to Congress [61] by April 18,

[61] These reports are to be submitted to the House Committee on Ways and Means and the Committee on Education and Labor, and to the Senate Committee on Finance and the Committee on Labor and Human Resources.

1985, on the proper role to be served by tax-exempt financing in the Guaranteed Student Loan and PLUS programs. These reports also are to make recommendations as to the appropriate arbitrage restrictions that should apply to qualified student bonds. Congress anticipated that, following receipt of these reports, it will review the issue of student loan bond arbitrage profits and will adopt statutory provisions eliminating any abuses that are found, but ensuring that such bonds may be used where they are needed to serve reasonable needs for student loan credit.

The Act further directs the Treasury Department to adopt new arbitrage restrictions for these bonds in the event that the Congress does not do so. These regulations may provide that restrictions similar to the additional arbitrage restrictions adopted by the Act for IDBs will apply to student loan bonds. Thus, Congress anticipated that earnings on debt service funds could be limited and that rebate requirements could be imposed with respect to nonpurpose obligations. Congress further anticipated that, in the case of student loan bonds, the rebate requirement might be extended to other obligations acquired in connection with qualified student loan bond programs.

The Act specifies that the regulations may provide that the statutory exceptions for earnings during certain temporary periods and for earnings on reasonably required reserve funds no longer apply to these bonds (sec. 103(c)(4). Additionally, the regulations may eliminate the rule providing special treatment for student assistance payments (sec. 103(c)(5).

If Congress does not enact new statutory rules, the Treasury Department regulations will become effective on the later of (1) the date that is six months after the regulations are proposed, or (2) the date that the Higher Education Act of 1965 is reauthorized (or expires, if earlier). These regulations generally would apply to all bonds issued on and after that date. An exception is provided, however, for certain bonds issued after that date. This exception applies to refunding bonds (1) where the amount of the refunding does not exceed 101 percent of the aggregate face amount of the refunded obligations, and (2) where the maturity date of any refunding obligation is not more than 17 years after the date on which the refunded obligation was issued. In the case of a series of refundings, the maturity date may not be more than 17 years after the date on which the original obligations were issued.

Additionally, the Act provides that the regulations would not apply to bonds issued to fulfill binding commitments of the issuer to acquire or finance student loan notes originated after June 30, 1984, and before the effective date of the regulations, but only if the commitments are binding on the effective date of the regulations and at all times thereafter. This exception applies only to commitments the amount of which is consistent with issuer's practices as of March 15, 1984, in establishing a secondary market for student loans. Congress intended, by this last restriction, to ensure that increased purchase commitments, in excess of reasonable student loan credit needs, are not made primarily to enable the issuer to issue additional tax-exempt bonds without regard to the new arbitrage restrictions.

Other student loan bonds

The Act provides that arbitrage restrictions similar to those provided under the Act for IDBs and those provided for mortgage subsidy bonds will apply to student loan bonds (other than qualified student loan bonds) issued after December 31, 1985. For example, a rebate requirement will be imposed with respect to arbitrage profits on these bonds like the requirement that is imposed with respect to qualified mortgage bonds. Because tax-exemption for interest on these bonds generally was terminated for bonds issued after July 18, 1984, these new arbitrage restrictions in practice will affect only those bonds for which exceptions were provided under the consumer loan bond provisions, discussed in Part B.

Option to issue taxable bonds

The Act clarifies that issuers of tax-exempt student loan bonds are permitted to elect to treat any bond issued by them as a taxable bond, without prejudice to the status of the issuer's outstanding or future tax-exempt bonds, or to the issuer's status as a tax-exempt organization. Congress intended that the Treasury Department will establish a specific procedure for making this election.

Executive branch jurisdiction over tax-exempt status of bonds

The Act clarifies that the Treasury Department has exclusive jurisdiction over any determination by the executive branch of the Federal Government as to whether interest on any obligation is exempt from tax under the Internal Revenue Code.

Treasury Department review of certain Department of Education determinations

The Act provides any issuer of student loan bonds may request the Treasury Department to review any determination by the Department of Education regarding the issuance of such bonds on a tax-exempt basis. The Treasury Department is required to establish procedures for conducting these reviews. Congress intended that this review procedure apply only in the case of adverse determinations by the Department of Education.

If the Treasury Department is requested to review an Education Department determination, Treasury must review all documents presented by the issuer that were considered by the Education Department in reaching its decision. Within sixty days, Treasury must make a decision as to whether the Department of Education determination is reasonable within the framework of the Student Loan Consolidation and Technical Amendments Act of 1983. Congress intended that the Department of Education will review any Treasury decision and take that opinion into account in its reexamination of its earlier determination.

Finally, the Act provides that any decision made pursuant to this review procedure does not affect the tax-exemption of interest on any student loan bond or of any issuer of such bonds.

Effective Date

Except as otherwise stated in the *Explanation of Provisions*, the provisions relating to student loan bonds are effective for such obligations issued after December 31, 1983.

Revenue Effect

The revenue effect of these provisions is included in the revenue effect of the provisions regarding private activity bonds (Part B).

D. Miscellaneous Tax-Exempt Bond Provisions

1. Treatment of Kansas City, Missouri and Kansas City, Kansas as a Unified Metropolitan Statistical Area (sec. 611(d)(5) of the Act)

Prior Law

The concept of a metropolitan statistical area (MSA) is used for various determinations under Federal law, including the determination of the purchase price limitations applicable to qualified mortgage bonds. Kansas City, Missouri and Kansas City, Kansas, together with surrounding counties, were designated as two separate metropolitan statistical areas under prior law.

Reasons for Change

Congress believed that the concept of a metropolitan statistical area should reflect accurately the economic nexus and population disbursement of a locality. In cases where two or more cities and surrounding counties form a single economic unit, Congress believed it inappropriate to designate the cities as separate MSAs solely on the basis of such factors as political (e.g., State) boundaries. Rather, Congress believed that closely related cities should be designated as a single, unified MSA, notwithstanding their location in different States.

Explanation of Provision

The Act provides that Kansas City, Missouri and Kansas City, Kansas (and specified surrounding counties) are to be designated as a single MSA for tax and all other purposes of Federal law.

Effective Date

This provision became effective on the date of enactment (July 18, 1984).

Revenue Effect

This provision is estimated to have a negligible impact on budget receipts.

2. Clarification of Public Approval Requirement in the Case of Certain Public Airports (sec. 628(f) of the Act)

Prior Law

Tax-exempt private activity bonds are required to be the subject of a public hearing before their issuance. Following the public hearing, issuance of such bonds must be approved by an elected official in the jurisdiction. In lieu of the public hearing and public official approval, issuance of the bonds may be approved by a voter referendum. Under prior law, in the case of facilities located in more than one jurisdiction, the issuing jurisdiction and all other jurisdictions in which the facilities were located were required to satisfy these public approval requirements.

Reasons for Change

Congress' purpose in enacting the Code's public approval requirements for private activity bonds was to ensure that these bonds were issued only after an opportunity for careful review by elected officials and affected members of the public. Congress believed that, generally, this review would limit the use of private activity bonds to the financing of facilities of significance to the issuing jurisdiction. After reexamining these rules, Congress determined that a narrow exception limiting the required public approval to that of the issuing jurisdiction in the case of publicly owned airports was consistent with the objectives of these requirements.

Explanation of Provision

The Act provides that in the case of airports located in more than one jurisdiction, but owned and operated by the jurisdiction issuing the tax-exempt bonds, only the issuing jurisdiction is required to satisfy the public approval requirements of the Code.

Effective Date

This provision applies to bonds issued after December 31, 1983.

Revenue Effect

This provision is estimated to have a negligible impact on budget receipts.

3. Treatment of the Power Authority of the State of New York as an Exempt Person for Purposes of the Tax-exempt Bond Provisions of the Code (sec. 629(a) and (c) of the Act)

Prior Law

Interest on State and local government obligations generally is exempt from Federal income tax. However, since 1968, tax-exemption generally has been denied to State and local government issues of industrial development bonds (IDBs). A State or local government bond is an IDB if (1) all or a major portion of the proceeds of the issue are to be used in any trade or business of a person other than a State or local government or tax-exempt organization, and (2) payment of principal or interest is secured by an interest in, or derived from payments with respect to, property or borrowed money used in a trade or business.

An exception to the denial of tax-exemption for interest on IDBs applies in the case of IDBs that are used to provide facilities for certain exempt activities. Such facilities include facilities for the local furnishing of electric energy (sec. 103(b)(4)(E)). A facility for the local furnishing of electric energy is defined in Treasury Department regulations as property for the furnishing of electric energy which is part of a system providing service to the general populace in a service area comprising no more than two contiguous counties. Treas. Reg. sec. 1.103-8(f)(2)(iii). In the Revenue Act of 1978, the definition of a facility for the local furnishing of electric energy was modified to include facilities for the furnishing of electric energy which are part of a system that provides electric energy to the general populace in a service area comprising no more than a city and one contiguous county.

The Power Authority of the State of New York (PASNY) is a State-owned and -operated utility that generates electric energy that it sells primarily to local, investor-owned utilities in that State. The local utilities may charge transmission fees to retail consumers, but may not mark up the actual cost of the electricity.

Reasons for Change

Congress reviewed and reaffirmed the general limitations on the use of tax-exempt financing by electric utilities to those utilities that serve only a limited, local service area. Congress believed, however, that a narrow exception was consistent with these limitations in the case of a State-owned and operated utility that did not qualify for such financing solely because it marketed the power it produces through local, investor-owned utilities, rather than operating its own transmission lines. To prevent undue benefit from accruing to entities not otherwise eligible to use tax-exempt financing as a result of this provision, however, Congress believed it appropriate that the investor-owned utilities not be permitted to mark up the price of such electricity to ultimate consumers.

Explanation of Provision

The Act provides that, subject to certain limitations,[62] PASNY will be treated as an exempt person for purposes of the tax-exempt bond provisions of the Code. Thus, the interest on bonds issued by PASNY generally will be tax-exempt. Under the Act, bonds issued by PASNY are subject to the new State volume limitation applicable to private activity bonds. Additionally, the total volume of bonds authorized to be issued under this provision is limited to $625 million, and the bond proceeds may be used only for the financing of transmission facilities, small hydroelectric facilities, and for the acquisition of an interest in an electrical generating facility.

Effective Date

The provision applies to bonds issued after the date of enactment (July 18, 1984) and also to bonds issued after 1969 that were treated as tax-exempt bonds under the Code when issued.

Revenue Effect

This provision is estimated to reduce fiscal year budget receipts by $1 million in 1984, $5 million in 1985, $12 million in 1986, $17 million in 1987, $18 million in 1988, and $18 million in 1989.

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[62] Among the limitations imposed by the Act is a requirement that any agreement between PASNY and a purchasing utility provide that there be no markup in the resale price charged by the purchasing utility of that component of the resale price that represents the price paid under the agreement for the output or use. This limitation does not preclude the purchasing utility from charging a resale price that reflects the costs of that utility's distribution facilities properly allocable to the distribution of that output or use (including a normal rate of return on such distribution facilities) as long as such price does not result an indirect markup on the output or use.

4. Tax-exempt Financing for Acquisition of Railroad Track and Rights of Way of Bankrupt Railroad (sec. 629(b) of the Act)

Prior Law

Interest on State and local government obligations generally is exempt from Federal income tax. However, since 1968, tax-exemption generally has been denied to State and local government issues of industrial development bonds (IDBs). A State or local government bond is an IDB if (1) all or a major portion of the proceeds of the issue are to be used in any trade or business of a person other than a State or local government or tax-exempt organization, and (2) payment of principal or interest is secured by an interest in, or derived from payments with respect to, property or borrowed money used in a trade or business.

An exception to the denial of tax-exemption for interest on IDBs applies in the case of IDBs that are used to provide facilities for certain exempt activities. Another exception provides that interest on the proceeds on certain "small issues" of IDBs may be tax-exempt. Small-issue IDBs generally may be used to finance improvements to land or any depreciable property. The aggregate face amount of an issue of small-issue IDBs may not exceed $1 million, unless a special election to consider certain capital expenditures over a six year period is made. If this election is made, a $10 million limit applies ($20 million in the case of property for which by a UDAG grant was received).

Under prior law, tax-exempt financing was available for the acquisition of facilities used in taxable businesses of railroads only if the requirements of the small-issue exception were satisfied.

Reasons for Change

Congress believed that a special exception to the IDB rules was justified in the case of the acquisition of property of a bankrupt railroad provided the Federal Railroad Administration provides joint financing for the acquisition. The IDB financing permitted by this exception will enable this railroad to continue operation and will, thereby, avoid economic disruption in the community it serves. Congress emphasized, however, that this exception is limited to the specific circumstances involved, and is not to be cited as support for any expansion of the general purposes for which tax-exempt financing is available.

Explanation of Provision

The Act provides that tax-exempt bonds may be issued to finance the acquisition of railroad track and rights-of-way from a bankrupt railroad where the Federal Railroad Administration provides joint financing for such facilities.

Effective Date

This provision applies to bonds issued after December 31, 1983.

Revenue Effect

This provision is estimated to reduce fiscal year budget receipts by less than $5 million annually.

5. Clarification of Treatment of Certain Exemptions for Purposes of the Federal Gift and Estate Taxes (secs. 641 and 642 of the Act)

Prior Law

Prior law provided (and present law provides) that interest on the obligations of a State, a Territory, or a possession of the United States (and political subdivisions of those entities) generally is exempt from Federal income tax. In addition to obligations described in the Internal Revenue Code, prior law provided tax-exemption for interest on a number of obligations which were not described in the Code. For example, section 11(b) of the Housing Act of 1937 provided that housing obligations issued under that Act were exempt from Federal taxation. The Surface Transportation Assistance Act of 1982 (P.L. 97-424) provided that tax-exemptions provided other than in the Code are deemed to have been provided by the Code.[63]

A United States District Court for the Northern District of Illinois ruled on April 25, 1983, that public housing project notes issued pursuant to the 1937 Housing Act were exempt not only from Federal income tax, but also from Federal gift and estate taxes. *Estate of Haffner* v. *U.S.*, No. 83C-4669 mem. op. (N.D. Ill., April 25, 1983). Bonds for which tax-exemption is provided under the Internal Revenue Code are not exempt from Federal gift and estate taxes.

Reasons for Change

Congress was extremely concerned over the opinion of the court in the *Haffner* decision that the 1937 Housing Act exempts public housing project notes from Federal gift and estate taxes. Traditionally, Congress had viewed exemptions from tax provided for certain types of bonds as applying only in the case of the income tax.

Although a Federal district court decision may be reversed on appeal, Congress was concerned that, in the interim, some persons might rely on this opinion to make transfers of these obligations and not report the transfers as subject to tax. If this occurred, it would be difficult to determine the occurrence of such transfers (and possibly to impose tax) after expiration of the additional time during which the appeals process with respect to this case is completed. Accordingly, Congress determined that special reporting requirements were necessary in cases where a transfer of these bonds

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[63] Section 628(a) of the Act provides that bonds for which tax-exemption formerly was provided other than in the Internal Revenue Code must satisfy appropriate requirements of the Code if the interest on such bonds is to be tax-exempt. This provision applies generally to bonds issued after December 31, 1983, and to public housing bonds issued pursuant to the 1937 Housing Act after June 18, 1984.

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occurred that was not reported as subject to Federal gift, estate or generation-skipping transfer tax.

Finally, although as stated above, Congress was extremely concerned over the *Haffner* opinion, it determined that the statutory provisions included in the Act should apply only to transfers occurring after June 18, 1984, rather than to past transfers. Because of its concern, however, Congress provided that no inference is to be drawn that transfers of such bonds occurring before that date are *not* subject to Federal gift or estate tax.

Explanation of Provisions

Exemption from tax

The Act provides that no obligations are exempt from Federal gift, estate, and generation-skipping transfer tax by virtue of a general provision of law. Rather, such an exemption arises only if the statute under which tax-exemption is granted specifically refers to the appropriate provisions of the Internal Revenue Code that impose those taxes. Therefore, any general grant of tax-exemption is to be interpreted as applying only to the income tax.[64] Additionally, Congress intended that tax-exemptions provided in laws enacted before the Act be construed as applying to Federal gift, estate, or generation-skipping transfer taxes only if those provisions of law specifically refer to those taxes (even if not to the actual Code provisions under which the taxes are imposed).

Reporting requirement for certain housing bond transfers

The Act imposes a special reporting requirement with respect to certain transfers of public housing notes occurring after December 31, 1983, and before June 19, 1984. This reporting requirement applies to all such transfers that are not reported as subject to Federal transfer tax. The Treasury Department is directed to adopt regulations prescribing the requirements for making these reports. The Act specifically directs Treasury to request all information necessary to impose transfer tax if the *Haffner* opinion is reversed. Additionally, the Act provides that failure to comply with this reporting requirement results in imposition of a penalty equal to 25 percent of the transfer tax that would have been due had the transfer been reported as subject to tax. This penalty is in addition to any tax ultimately determined to be due on the transfer.

Effective Date

These provisions apply generally to estates of individuals dying, gifts made, and transfers occurring after June 18, 1984. The provisions also apply to transfers occurring before June 19, 1984, if the transfers previously were reported as subject to Federal transfer tax. No claims for refunds may be filed, therefore, with respect to such transfers.

The Act further provides that no inference is to arise from the fact that the new statutory provisions apply only to transfers after

[64] Section 628(a) of the Act further provides that interest on obligations is exempt from income tax only if the obligations satisfy the appropriate requirements of the Code and that such exemptions must be enacted by a revenue Act (Code sec. 103(m), as amended by the Act).

June 18, 1984, that transfers before that date were *not* subject to tax.

As stated above, the special reporting requirements apply to transfers occurring after December 31, 1983, and before June 19, 1984.

Revenue Effect

The revenue effect of this provision is included in the revenue effect of the provisions relating to private activity bonds (Part B).

6. Tax-exempt Status of Obligations of Pennsylvania State University (sec. 643 of the Act)

Prior Law

Interest on State and local government obligations generally is exempt from Federal income tax. Treasury Department regulations provide that State and local obligations include obligations issued by or on behalf of a State or local governmental unit by authorities empowered to issue such obligations. Treas. Reg. sec. 1.103-1(b). The courts have held that whether an obligation has been issued by a State or local government unit depends on a variety of factors, including the degree of sovereign power exercised by the issuing authority and the relationship of the authority to the State or local government.[65] Similarly, several requirements must be satisfied in order for an issuer to qualify as a constituted authority that is issuing obligations on behalf of a State or local governmental unit. (See Rev. Rul. 57-187, 1957-1 C.B. 65; Rev. Rul. 63-20, 1963-1 C.B. 26.[66]

Reasons for Change

Interest on obligations issued by a State university is tax-exempt if such State university is either a political subdivision of the State or is acting on behalf of a State. For technical reasons, obligations of Pennsylvania State University may not have been exempt under either of these alternatives. Congress examined the operations of the Pennsylvania State University and its relationship with the Commonwealth of Pennsylvania and determined that the operations of that university are sufficiently a part of the operations of the Commonwealth of Pennsylvania and its relationship to the Commonwealth of Pennsylvania is sufficiently close that interest on the obligations of this university should be exempt from Federal income tax. Thus, Pennsylvania State University will be given equal treatment under Code section 103 with those State universities that are either a political subdivision of the State or acting on behalf of a State.

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[65] *Commissioner* v. *Shamberg's Estate*, 144 F.2d 998 (2d Cir. 1944), *cert. den.*, U.S. 792 (1945); *Philadelphia Nat'l Bank* v. *U.S.*, 666 F.2d 834 (3d Cir. 1981), *cert. den.*, 102 S. Ct. 2904 (1982).

[66] *See also*, Prop. Treas. Reg. sec. 1.103-1(c)(2). These proposed regulations provided that these requirements generally are satisfied if: (1) the authority is specifically authorized pursuant to State law to issue obligations to accomplish public purposes of the unit; (2) the unit controls the governing board of the authority; (3) the unit has either organizational control over the authority or supervisory control over the activities of the authority; (4) any net earnings of the authority (beyond those necessary for retirement of the indebtedness or to implement the public purposes or program of the unit) may not inure to the benefit of any person other than the unit; (5) upon dissolution of the authority, title to all property owned by the authority will vest in the unit; and (6) the authority is created and operates solely to accomplish one or more of the public purposes of the unit specified in the authorization of the unit. The proposed regulations were withdrawn on December 16, 1983. The statement accompanying the withdrawal indicated that prior rulings relating to entities issuing obligations on behalf of a State or local governmental unit form the primary source of guidance on this question. 48 *Fed. Reg.* 55878 (Dec. 16, 1983).

Explanation of Provision

The Act provides that the Pennsylvania State University is to be treated as a State governmental unit for purposes of the tax-exempt bond provisions of the Internal Revenue Code (sec. 103). Interest on obligations of the University will qualify, therefore, for tax-exemption, subject to all of the limitations applicable to obligations issued by a State. The provision does not apply to bonds issued with respect to trades or businesses carried on by the Pennsylvania State University that would constitute unrelated trades or businesses under the Code provisions regarding unrelated business taxable income.

Effective Date

This provision applies generally to obligations to which the Internal Revenue Code of 1954 is applicable.

Revenue Effect

This provision is estimated to reduce fiscal year budget receipts by less than $10 million annually.

7. Expansion of Exemption for Bonds Issued for the Local Furnishing of Electricity (Long Island Lighting Company) (sec. 644 of the Act)

Prior Law

Interest on State and local government obligations generally is exempt from Federal income tax. However, since 1968, tax-exemption generally has been denied to State and local government issues of industrial development bonds (IDBs). A State or local government bond is an IDB if (1) all or a major portion of the proceeds of the issue are to be used in any trade or business of a person other than a State or local government or tax-exempt organization, and (2) payment of principal or interest is secured by an interest in, or derived from payments with respect to, property or borrowed money used in a trade or business.

An exception to the denial of tax-exemption for interest on IDBs applies in the case of IDBs the proceeds of which are used to provide facilities for certain exempt activities. Such facilities include facilities for the local furnishing of electric energy (sec. 103(b)(4)(E)). A facility for the local furnishing of electric energy is defined in Treasury regulations as property for the furnishing of electric energy that is part of a system providing service to the general populace in a service area comprising no more than two contiguous counties. (Treas. Reg. sec. 1.103-8(f)(2)(iii)). In the Revenue Act of 1978, the definition of a facility for the local furnishing of electric energy was modified to include property for the furnishing of electric energy which is part of a system that provides electric energy to the general populace in a service area comprising no more than a city and one contiguous county.

Reasons for Change

Congress was informed that, in the case of the Long Island Lighting Company (LILCO), a peculiar geographical circumstance precluded what, in substance, is a local electric utility from satisfying the Code requirements for tax-exempt financing. Congress believed, that in this case, substance should govern over form (i.e., political boundaries) and tax-exempt financing should be available to LILCO subject to all restrictions generally applicable to the use of such financing by other qualified electric utilities.

Explanation of Provisions

The Act provides that a utility (LILCO) is qualified under the rule permitting tax-exempt financing for such utilities engaged in the local furnishing of electric energy if (1) at least 97 percent (measured both by total number of metered customers and by their annual consumption on a kilowatt hour basis) of the retail customers of the system are located in two contiguous counties and (2) if the remainder of such customers are located in a portion of a third contiguous county which is on a peninsula not directly connected by land to the remainder of the county of which it is a part.

The State volume limitation enacted by the Act applies to bonds issued under the exemption for local furnishing of electricity; therefore, the bonds issued pursuant to this exception also will be subject to that general rule. Because of unique financing needs of LILCO, however, the Act authorizes the State of New York to use in 1984 up to one-half of its State volume limitation for 1985, 1986, and 1987, for LILCO. The Treasury Department is to prescribe regulations establishing the procedures by which this special allocation may take place.

Effective Date

This provision became effective with respect to bonds issued after December 31, 1983.

Revenue Effect

This provision is estimated to reduce fiscal year budget receipts by $14 million in 1985, $58 million in 1986, $105 million in 1987, $118 million in 1988, and $112 million in 1989.

8. Expansion of Exemption for Bonds Issued for the Local Furnishing of Electricity (Bradley Lake Hydro-electric Facility (Alaska)) (sec. 645 of the Act)

Prior Law

Interest on State and local government obligations generally is exempt from Federal income tax. However, since 1968, tax-exemption generally has been denied to State and local government issues of industrial development bonds (IDBs). A State or local government bond is an IDB if (1) all or a major portion of the proceeds of the issue are to be used in any trade or business of a person other than a State or local government or tax-exempt organization, and (2) payment of principal or interest is secured by an interest in, or derived from payments with respect to, property or borrowed money used in a trade or business.

An exception to the denial of tax-exemption for interest on IDBs applies in the case of IDBs the proceeds of which are used to provide facilities for certain exempt activities. Such facilities include facilities for the local furnishing of electric energy (sec. 103(b)(4)(E)). A facility for the furnishing of electric energy is defined in Treasury regulations as property for the furnishing of electric energy that is part of a system providing service to the general populace in a service area comprising no more than two contiguous counties. (Treas. Reg. sec. 1.103-8(f)(2)(iii)). In the Revenue Act of 1978, the definition of a facility for the local furnishing of electric energy was modified to include property for the furnishing of electric energy which is part of a system that provides electric energy to the general populace in a service area comprising no more than a city and one contiguous county.

Reasons for Change

Congress was informed that, in the case of the Bradley Lake Hydro-electric Facility in Alaska, peculiar geographical circumstances and population disbursement render it impractical to satisfy the requirements of the Code defining a facility engaged in the local furnishing of electric energy. Congress was persuaded that a narrow exception to this rule is justified in light of these conditions and also the fact that the State of Alaska has made a substantial direct financial commitment to the construction of the facility. Congress determined, however, that all other restrictions of the Code applicable to tax-exempt IDBs should apply to bonds to finance this facility.

Explanation of Provision

The Act provides that the Bradley Lake Hydro-electric Facility in Alaska (initially approved by the Federal Government in 1962) is to be treated as a facility for the local furnishing of electricity under the tax-exempt bond provisions of the Code, provided that facility satisfies the following two requirements:

(1) The facility receives financing of at least 25 percent of its cost from the State of Alaska; and

(2) The electric energy generated by the facility is purchased by an electric cooperative qualified as a rural electric borrower under 7 U.S.C. 901 *et. seq.*

Effective Date

This provision is effective with respect to bonds issued after December 31, 1983.

Revenue Effect

This provision is estimated to reduce fiscal year budget receipts by less than $10 million annually.

9. Authority for the District of Columbia and Certain Possessions to Issue Certain Tax-exempt Bonds (sec. 647 of the Act)

Prior Law

Subject to certain restrictions, interest on obligations issued by or on behalf of States, and territories and possessions of the United States, is exempt from Federal income tax (Code sec. 103). The term State is defined to include the District of Columbia (sec. 7701(a)(10)). Federal law generally does not authorize the issuance of any type of bonds, however, including industrial development bonds and mortgage subsidy bonds. Authority to issue bonds is a matter of State, local, or territorial law. In the case of the District of Columbia and the U.S. possessions, the authority to issue bonds is contained in the applicable home rule statute (D.C.) or the organic Acts under which the government of the applicable possession is organized (the Virgin Islands and American Samoa). As a result of the general questions concerning home rule in the District of Columbia arising from the decision in *INS* v. *Chada*,[67] the authority of the District to issue tax-exempt bonds was unclear under prior law.

Reasons for Change

Provided that their use of tax-exempt financing complies with the restrictions included in Federal law, Congress believed that the District of Columbia, the Virgin Islands, and American Samoa should have access to the benefits derived therefrom. Because of general questions concerning home rule in the District of Columbia, Congress determined that, at the present time, it should authorize that jurisdiction only to issue industrial development bonds to finance residential rental property for low- and moderate-income tenants and mortgage subsidy bonds, for which the District specifically demonstrated a present need.

Explanation of Provision

The Act authorizes the District of Columbia Housing Finance Agency to issue tax-exempt industrial development bonds for low - and moderate-income residential rental property (sec. 103(b)(4)(A)) and mortgage subsidy bonds (sec. 103A). In taking this action, Congress specifically intended to reverse the *Chadha* decision as to issuance of these obligations.

The Act authorizes the Virgin Islands and American Samoa to issue industrial development bonds (within the meaning of the Internal Revenue Code). In applying the State volume limitations provided under the Act, the per capita limitations, but not the min-

[67] 462 U.S. 919 (1983).

imum $200 million floor, are to apply with respect to these possessions. The other requirements of the Code governing the tax-exemption of industrial development bonds also apply to such bonds issued by these possessions.

Effective Date

This provision is effective for obligations issued after December 31, 1983.

Revenue Effect

The revenue effect of this provision is included in the revenue effect of the provisions relating to private activity bonds (Part B).

10. Exemption from Arbitrage Rules for Texas Permanent University Fund (sec. 648 of the Act)

Prior Law

Interest on obligations (including IDBs or other State or local obligations) that are treated as arbitrage bonds is not tax-exempt. An arbitrage bond is defined as an obligation that is part of an issue all or a major portion of the proceeds of which are to be used (directly or indirectly) to acquire taxable obligations that produce a materially higher yield than the yield on the tax-exempt obligations (or to replace funds that are so used). Exceptions are provided permitting materially higher yielding obligations held for a temporary period or in a reasonably required reserve or replacement fund.

There is no statutory definition of what constitutes a "materially higher" yield. However, Treasury Department regulations provide rules for purposes of determining when an obligation acquired with the proceeds of tax-exempt bonds has a yield materially higher than the bond yield. In general, a yield more than 0.125 percent above the bond yield is considered materially higher. In the case of certain obligations, such as student loans and loans to provide housing, the yield on the acquired obligations may exceed the bond yield by as much as 1.5 percent.

Under a provision of the Texas State Constitution adopted in 1876, certain State lands were set aside for the benefit of higher education. The income from mineral rights to these lands is required to be held in a Permanent University Fund, also established by that Constitution. The Texas Constitution directs that monies held in the Fund are to be invested in interest-bearing obligations and other securities. The Constitution does not permit the expenditure or mortgage of the Fund for any purpose. The income from the investments held by the Fund is apportioned between the University of Texas and Texas A & M University.

Bonds are issued by the University of Texas system and the Texas A & M University system that are secured by and payable from the income of the Fund. These bonds are used to finance buildings and other permanent improvements for the universities. The State Constitution further stipulates that general revenues of the State or general obligation bonds may not be used for these purposes.

Reasons for Change

The arbitrage restrictions of the Code are designed to prohibit State and local governments from taking unfair advantage of their tax-exempt bond privileges by issuing low yield tax-exempt bonds and purchasing higher yield securities or obligations issued by the

United States Treasury Department or private financial institutions. This arrangement would enable these governmental units to profit from the differential between the relatively low debt service they incur on their tax-exempt bonds and the higher rate of return available from taxable obligations and securities. The restrictions also are intended to prevent the issuance of tax-exempt bonds when other funds are available for the same purpose as the bond issue, but such funds instead are used to purchase high-yield stocks or bonds, thereby resulting in an indirect method of benefitting from the yield differential.

The Code arbitrage restrictions were enacted in 1969; the Texas Permanent University Fund has been in existence in substantially the same form since 1876. Therefore, Congress determined that an exception for the Texas Fund was appropriate in light of its long history. Congress believed that this history demonstrates that the Texas Fund's procedures were not established as a device to take unfair advantage of the privilege of issuing tax-exempt bonds. Congress did not feel, however, that exceptions to the arbitrage bond restrictions are appropriate for funds established by State law (or any other authority) subsequent to the enactment of the Code arbitrage restrictions, or for funds that only began regularly issuing bonds after that time.

Explanation of Provision

The Act provides an exception to the arbitrage restrictions for a fund, (the Texas Permanent University Fund) where the fund was created before October 9, 1969, and earnings from investments held in the fund are applied to pay all or a portion of the debt service on bond issues. To qualify for this exception, the corpus of the fund may not be used to pay the debt service on any bond issues; only investment earnings (e.g., interest or dividends) from the investment of the corpus of the fund may be used to pay debt service. These restrictions on the use of the corpus of the fund must have been established by State statutory or constitutional requirements that were adopted before October 10, 1969, and that have been in effect continuously since at least October 9, 1969.

The exception further is limited so that the fund may not have received any substantial discretionary contributions after October 9, 1969. Any growth in the fund solely as a result of rental income, royalties, dividends, or investment earnings derived from assets already in the fund is not treated as a discretionary contribution. A gift or bequest to the fund would be so treated.

A fund also will not qualify for this exception from the arbitrage yield restrictions unless during the period beginning on January 1, 1960, and ending on October 9, 1969, at least two issues payable from its investment earnings were issued. In addition, the exception will not continue to be effective for any issuer where the issuer fails to issue at least one issue of bonds payable from the fund's investment earnings during each five-year period commencing on October 9, 1969, and every fifth anniversary thereafter. For example, if an issuer fails to issue any bonds payable from the income of the fund between October 9, 1984, and October 8, 1989, any bonds issued by such issuer after October 8, 1989, will not qualify under this exception, and the investments in the fund will be subject to the arbitrage restrictions applicable to tax-exempt bonds on the date on which such bonds are issued.

Congress intended that if more than one issuer issues bonds payable from the investment earnings of the fund, and only one such issuer fails to issue bonds during any five-year period after October 9, 1969, the exception will cease to apply only with respect to the issuer failing continuously to issue bonds. For example, if the Board of Regents of the University of Texas system issued bonds during any such five-year period and the Board of Regents of the Texas A & M University system failed to issue bonds during such five-year period, only the Board of Regents of the University of Texas system could issue bonds under the exception in subsequent years.

Finally, the principal amount of bonds issued under the exception may not exceed the principal amount that could be issued under State constitutional or statutory restrictions as of October 9, 1969. This requirement relates to the method provided under State law on that date for determining the amount of bonds that may be issued,[68] and not to restrictions on the purposes for which such bonds may be issued.

Effective Date

This provision became effective on July 18, 1984.

Revenue Effect

The revenue effect of this provision is included in the revenue effect of the provisions relating to private activity bonds (Part B).

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[68] The applicable method is determined based upon the facts and circumstances at the time the bonds actually are issued.

TITLE VII—TECHNICAL CORRECTIONS[1]

The Technical Corrections title contains technical, clerical, conforming and clarifying amendments to provisions enacted by the Tax Equity and Fiscal Responsibility Act of 1982, the Subchapter S Revision Act of 1982, the Highway Revenue Act of 1982, and other recently enacted tax legislation. All amendments made by the title are meant to carry out the intent of Congress in enacting the original legislation.

A. Technical Corrections to the Tax Provisions of the Tax Equity and Fiscal Responsibility Act of 1982

1. Alternative Minimum Tax (sec. 711(a) of the Act and secs. 55-58 of the Code)

Prior Law

TEFRA[2] added several new tax preferences and made certain other modifications to the individual alternative minimum tax. This tax is computed at a 20-percent rate and is payable to the extent it exceeds the taxpayer's regular tax. Regular tax generally means the taxpayer's income tax liability reduced by nonrefundable credits. TEFRA generally allowed individuals to elect to take ACRS deductions and the investment tax credit with respect to intangible drilling costs. Also TEFRA provided that the circulation expense deduction, to the extent it exceeded a deduction based on 10-year amortization, was a tax preference for individuals.

Explanation of Provision

In order that a taxpayer may not avoid recapture of investment tax credit on disposition of investment credit property by reason of being subject to the alternative minimum tax, the Act clarifies that the amount of investment credit recapture is not included in the taxpayer's regular tax for purposes of computing alternative minimum liability. As a result, the recapture tax will be a liability in addition to the taxpayer's alternative minimum tax and regular tax.

The Act provides that the election to take ACRS deductions and the investment credit in lieu of expensing intangible drilling costs will not be available with respect to oil, gas and geothermal wells which are not located in the United States, since the investment

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[1] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, subtitles A-C of title VI; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1611-1651; H. Rep. No. 98-861 (June 23, 1984), pp. 1218-1228 (Conference Report); and H. Con. Res. 328, 130 Cong. Rec. H 7529 and S 8947 (June 29, 1984).

[2] The Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248).

credit is generally not allowable for property used outside the United States.

The Act provides that the amount includible in gross income with respect to the alcohol fuels credit (sec. 87) will not be included in alternative minimum tax since that credit is not allowed against the minimum tax.

Further, the Act amends the circulation expense tax preference provisions by providing a 3-year amortization period (rather than the 10-year period) for individuals to amortize circulation expenses and to measure the tax preference where the expenses are deducted in full under section 173.

Finally, the Act clarifies that items of income and deductions from a limited business interest are taken into account in computing net investment income for purposes of the limitation on interest deductions, whether or not the deductions from the business interest exceed the income from that interest. This provision may be illustrated by the following example.

Assume that a taxpayer had $100,000 of dividend income and also held a limited partnership interest in a partnership all of whose income is derived from a trade or business. The taxpayer's distributive share of partnership income included $200,000 of gross income and $300,000 of deductions which are not preferences (including partnership deductions for business interest). Because any income or loss derived from the limited partnership interest is taken into account for purposes of computing net investment income, the taxpayer would have no net investment income for the taxable year and, therefore, could deduct no "below the line" interest (other than eligible housing interest), including interest on debt used to purchase or carry the limited partnership interest.

2. Casualty Loss Deduction (sec. 711(c) of the Act and sec. 165 of the Code)

Prior Law

TEFRA provided that the itemized deduction for nonbusiness casualty and theft losses is allowed only to the extent the losses exceed 10 percent of the taxpayer's adjusted gross income. In determining adjusted gross income, the deduction for capital gain (under sec. 1202) is allowed. Where a taxpayer's recognized gains from certain involuntary conversions or other casualty losses are in excess of the recognized losses for those transactions for a taxable year, the taxpayer's capital gains deduction for that year, and therefore his or her adjusted gross income, may have depended on the amount of casualty loss which is allowable as a deduction (sec. 1231). Thus, in certain circumstances, the computation of the casualty loss deduction may not have been mathematically determinable because of the interrelationship with the adjusted gross income determination.

Explanation of Provision

For taxable years beginning after December 31, 1983, the Act provides that gains and losses from an involuntary conversion of property described in section 165(c)(3) arising from fire, storm, shipwreck, or other casualty or from theft will no longer be subject to the application of section 1231. Section 1231 will thus be applied without regard to these gains and losses. Gains and losses from these personal casualties (without regard to the period the property was held) will be netted. If the recognized gains exceed the recognized losses from these transactions, then all such gains and losses will be treated as gains and losses from the sale or exchange of a capital asset, and the losses will not be subject to the 10-percent floor. (The amount of any recognized loss will be subject to the $100 floor before netting). If the recognized losses exceed the recognized gains, all gains and losses will be ordinary. Losses to the extent of gains will be allowed in full. Losses in excess of gains will be subject to the 10 percent adjusted gross income floor.

Thus, for example, assume a taxpayer has $100,000 of adjusted gross income (without regard to casualty gains and losses described in section 165(c)(3)), $50,000 of such casualty gains, and $40,000 of such casualty losses (after applying the $100 floor) for a taxable year. All the taxpayer's personal casualty gains and losses for that year will be treated as capital gains and losses. The 10-percent floor will not be applicable. Assume, however, that the taxpayer's losses for the year are $70,000 rather than $40,000. The gains and losses will all be treated as ordinary. $60,000 of losses will be allowed as a deduction ($50,000 plus the $10,000 excess of the remaining $20,000 over the $10,000 (10 percent of $100,000) AGI floor).

For taxable years beginning in 1983 the Act provides that adjusted gross income, for purposes of computing the 10-percent floor for the casualty loss deduction, is determined without regard to the application of section 1231 to gains or losses from involuntary conversions arising from casualty or theft.

The Act also clarifies that the adjusted gross income limitation applies to estates and trusts.

3. Corporate Minimum Tax (sec. 712(a) of the Act and sec. 291 of the Code)

Prior Law

TEFRA provided a 15-percent cutback in certain corporate tax preferences. These preferences include section 1250 recapture on real estate, mining exploration and development costs, interest incurred by financial institutions to carry certain tax-exempt obligations, DISC, and intangible drilling costs of integrated oil companies.

Explanation of Provision

The Act provides that the additional gain recognized as ordinary income on the disposition of section 1250 property under the cutback provision is treated, for all purposes of the Code (such as sections 170, 341, 453, 453B and 751), in the same manner as other section 1250 gain. Since the investment tax credit is generally not allowed for property used outside the United States, the Act provides that no investment credit is allowed for mineral exploration and development costs with respect to mineral deposits located outside the United States. The Act clarifies that, for purposes of applying the preference cutback with respect to interest of financial institutions used to carry tax-exempt bonds, amounts paid in respect of deposits, investment certificates, or withdrawable or repurchased shares are treated as interest, whether or not designated as interest. Finally, the Act clarifies the language providing for the 36-month amortization of drilling and mining costs which are otherwise disallowed by the section.

4. Investment Tax Credit Basis Adjustment (sec. 712(b) of the Act and sec. 48(q) of the Code)

Prior Law

TEFRA provided a basis adjustment for property with respect to which the investment tax credit is allowed.

Explanation of Provision

The Act clarifies that the basis in a partnership or S corporation is adjusted to reflect adjustments to the basis of partnership or S corporation property where investment credits are either allowed or recaptured. No double basis reductions are intended. In the case of an S corporation, corresponding adjustments are to be made to the accumulated adjustments account.

5. Construction Period Interest and Taxes (sec. 712(c) of the Act and sec. 189 of the Code)

Prior Law

TEFRA provided that corporations must capitalize construction period interest and taxes with respect to nonresidential real property.

Explanation of Provision

The Act clarifies that construction period interest and taxes with respect to dwelling units in a cooperative housing corporation (as defined in sec. 216) is exempt from the TEFRA capitalization requirement, since that property is residential property.

6. Leasing (sec. 712 (d) and (h) the Act, sec. 168 of the Code, and secs. 210 and 217(e) of TEFRA)

a. Mass commuting vehicles

Prior Law

In general, TEFRA modified the safe-harbor leasing rules for leases entered into or property placed in service after July 1, 1982, and repealed safe-harbor leasing for leases entered into after December 31, 1983. However, the TEFRA modifications and repeal of the safe-harbor leasing rules did not apply to qualified mass commuting vehicles. A qualified mass commuting vehicle must be financed in whole or in part by obligations the interest on which is excludable from income.

TEFRA also included a provision to specifically designate ferries as mass commuting vehicles. The effective date of this provision was generally for obligations issued after the date of enactment of TEFRA.

Explanation of Provision

The Act clarifies that, for purposes of safe-harbor leasing, the provision designating ferries as mass commuting vehicles applies to agreements entered into after the date of enactment of TEFRA, without regard to the date on which obligations were issued.

b. Motor vehicle leases

Prior Law

Prior to the enactment of TEFRA, the Internal Revenue Service took the position that the presence of a terminal rental adjustment clause in a motor vehicle lease would cause the transaction to be treated as a conditional sale for tax purposes.[3] However, TEFRA provided that the presence of a terminal rental adjustment clause was not to be taken into account in determining whether an agreement is a lease. The TEFRA provision was intended to prevent the Internal Revenue Service from retroactively denying lease treatment for certain motor vehicle leases. The TEFRA provision defines a terminal rental adjustment clause as a provision of an agreement that permits or requires the rental price to be adjusted upward or downward by reference to the amount realized by the lessor under the agreement upon sale or other disposition of the property.

Explanation of Provision

The Act makes two clarifying amendments to the TEFRA provision for terminal rental adjustment clauses.

The Act clarifies that the term "terminal rental adjustment clause" also includes a provision of an agreement that requires a lessee who is a dealer in motor vehicles to purchase the property for a predetermined price and then resell the property, where such a provision achieves substantially the same results as a provision that permits an upward or downward adjustment of rentals after the disposition of the property by a lessor.

The Act also provides that the TEFRA provision shall not apply to the lessee of a motor vehicle agreement if the lessee treated itself as the owner of the motor vehicle, with respect to the investment tax credit, on a Federal income tax return that was filed before the date of the enactment of TEFRA.

7. Foreign Taxation (sec. 712 (e) and (f) of the Act and sec. 907 of the Code)

a. Recapture of foreign oil losses

Prior Law

TEFRA eliminated the separate foreign tax credit limitation for foreign oil income. Absent relief, the Code's foreign loss recapture

[3] Technical Advice Memorandum 8019120 (December 20, 1979)

rule would cause immediate recapture of one kind of loss (oil or non-oil) against the other kind of income. A special rule, however, limited recapture to 12.5 percent of the pre-TEFRA loss per year. In some cases, however, taxpayers may prefer recapture more rapid than the ratable 12.5 percent per year recapture of present law. For instance, a taxpayer who anticipates receipt of low-taxed foreign source income in the near future and receipt of high-taxed foreign source income in later years may prefer more rapid recapture. In providing relief for taxpayers who benefit from ratable 12.5 percent recapture, Congress did not intend to penalize other taxpayers.

Explanation of Provision

The Act makes clear that taxpayers can elect recapture of one kind of loss (oil or non-oil) over a period shorter than eight years.

b. Definition of foreign oil related income

Prior Law

TEFRA imposed current U.S. tax on the U.S. shareholders of controlled foreign corporations that earn foreign base company oil related income. Foreign base company oil related income for this purpose means certain foreign oil related income as defined in section 907(c)(2).

Explanation of Provision

The Act supplements the definition of foreign base company oil related income by specifying that the term also includes foreign oil related income as defined in section 907(c)(3). The term will include certain dividends, interest, deemed distributions under the Subpart F rules, and partnership income. The term will include these amounts only to the extent they constitute foreign oil related income; the term will not include amounts that constitute foreign oil and gas extraction income.

8. Partial Liquidations (sec. 712(i) of the Act and sec. 543 of the Code)

Prior Law

TEFRA provided that distributions to corporate shareholders in a partial liquidation are excluded from the definition of personal holding company income notwithstanding that they otherwise constitute dividends under the revised treatment of partial liquidations.

Explanation of Provision

In order to treat all dividends in the same manner, the Act deletes this exclusion so that dividends otherwise constituting personal holding company income will be so treated notwithstanding that they are made in a partial liquidation of the distributing corporation.

9. Distribution of Appreciated Property in Redemption of Stock (sec. 712(j) of the Act and sec. 311 of the Code)

Prior Law

Generally, distributions of appreciated property result in recognition of gain to the distributing corporation. Prior to the Act, gain recognition was limited to stock redemption distributions. TEFRA excepted from the recognition requirement distributions in partial liquidation and certain distributions of stock or obligations of a controlled corporation if made with respect to qualified stock. Qualified stock is stock held by a noncorporate shareholder who has held at least a 10-percent interest in the distributing corporation for 5 years prior to the distribution (or such lesser period as the distributing corporation or its predecessor existed). The treatment of distributions made to pass-through entities was not entirely clear under the language of TEFRA.

Explanation of Provision

The Act amends the rules relating to qualified stock to provide that, in determining whether the definition of qualified stock is satisfied, distributions to pass-through entities (S corporations, partnerships, trusts, and estates) will be treated as if made directly to the shareholders, partners, or beneficiaries in proportion to their respective interests in the entity. Thus, for example, a distribution to a partnership will not qualify as a distribution with respect to qualified stock to the extent that interests in the partnership are owned by corporations. Further, distributions will not qualify to the extent of an interest in the partnership held by any person whose interest is less than 10 percent, unless stock attributable to such interest when combined with other stock held actually or constructively by such person satisfies the 10-percent requirement. Further, regardless of how long the partnership held the stock in the distributing corporation, the distribution will not satisfy the holding period requirement to the extent it is attributable to a partner whose interest in the partnership was acquired within 5 years (or within such shorter period as the distributing corporation or its predecessor existed) prior to the distribution. Where, however, the stock was contributed to the partnership by the partner, the combined period of ownership by the partner and the partnership will constitute the holding period applicable to the partner.

10. Treatment of Certain Stock Purchases (sec. 712(k) of the Act and sec. 338 of the Code)

a. Definition of purchase for treating certain stock purchases as asset acquisitions

Prior Law

A corporation making a qualified stock purchase may treat the acquisition as if the assets of the acquired corporation were purchased. Prior to TEFRA, this treatment applied only if the acquired corporation was liquidated. Under the TEFRA revision of prior law, if the purchasing corporation elects such treatment, the acquired corporation is treated as a new corporation which purchased the assets as of the beginning of the day after the date the qualified stock purchase was completed. Generally, the election may be made only if 80 percent or more of the stock (other than certain nonvoting preferred stock) of the acquired corporation is purchased within a 12-month period.

Under TEFRA, stock owned by the acquired corporation in a third corporation was treated as purchased by the acquiring corporation if, as a result of the purchase of stock of the acquired corporation, the acquiring corporation was treated as constructively owning stock in such third corporation. When a corporation (the first corporation) purchases 80 percent of the qualifying stock of another corporation (the second corporation) which in turn owns 80 percent of the stock of a third corporation, the first corporation had not made a qualified stock purchase of the third corporation because it was treated as having purchased only 64 percent (80 percent of 80 percent) of the qualifying stock of such third corporation. However, if an election was made with respect to the qualified stock purchase of the second corporation, the second corporation would be treated as a new corporation which had purchased 80 percent of the third corporation's stock. It was not clear whether such deemed purchase was a qualified stock purchase which enabled the second corporation to make an election with respect to the third corporation.

An acquisition of stock or assets made by a member of the same affiliated group as the purchasing corporation was treated as made by the purchasing corporation for purposes of certain rules deeming asset sale treatment to apply to a qualified stock purchase.

Explanation of Provision

The Act generally conforms the definition of purchase to the definition of prior law (section 334(b)(2)). Under the Act, a purchasing corporation will not be treated as having purchased stock in a third corporation which it constructively owns as a result of purchasing the stock in another (the second) corporation. Instead, if a qualified stock purchase and election are made with respect to the second corporation, the deemed purchase of the third corporation's stock will (if it satisfies the 80-percent ownership requirement) be treated as a qualified stock purchase permitting a separate election by the second corporation, and deeming an election to be made under certain consistency of treatment requirements, with respect to the third corporation. The acquisition date applicable to the deemed sale by the second corporation is to be determined under regulations. The regulatory authority is intended to enable the Treasury Department to provide a single acquisition date when sec. 338 is applied to the direct purchase of a target corporation which is the parent corporation of an affiliated group.

Generally, under the Act, an election may be made only by a corporation which has made a direct acquisition by purchase of stock satisfying the 80-percent ownership requirement. For this purpose, stock acquired (including stock acquired in a carryover basis transaction after a qualified stock purchase and election with respect to the transferor) from a related corporation, in a transaction which otherwise satisfies the "purchase" requirement, will be treated as purchased if at least 50 percent in value of the stock of the related corporation was acquired by purchase. A corporation is related if stock owned by it is owned by the acquiring corporation. The 12-month acquisition period with respect to a qualified stock purchase commences, under the Act, not later than the date on which an acquiring corporation first constructively owns stock (other than through ownership of an option) included in such qualified stock purchase which is acquired from a related corporation.

Under the Act, stock acquired in the course of certain reorganizations and other transactions set forth in regulations in which the transferor does not recognize the entire amount of gain shall be treated as not purchased.

The Act provides that stock or asset acquisitions by 2 or more members of the same affiliated group will be treated as made by one corporation. Thus, the aggregate purchases of target corporation stock by several members of an affiliated group will be counted in determining whether there has been a qualified stock purchase. Similarly, the deemed sales price and basis of a target corporation's assets and gain recognized under section 338(c)(1) will be determined on a group basis. The application of this provision to the consistency rules was not changed.

These rules will not apply to a taxpayer making a qualified acquisition before September 1, 1982, or to any qualified acquisition (determined under prior law) before October 20, 1983, unless the taxpayer elects to have the new definition of "purchase" apply.

b. Limitation on nonrecognition of gain or loss in certain stock purchases treated as asset acquisitions

Prior Law

When an election resulted in treating an acquired corporation as having sold its assets, gain or loss was not recognized on such constructive sale to the same extent as gain or loss would not be recognized under the rules applicable to an actual sale of assets by, and liquidation of, the acquired corporation (under sec. 337). However, where less than all the stock of such corporation was owned by the acquiring corporation, the portion of the gain or loss not recognized was limited to the highest percentage by value of the acquired corporation's stock owned by the acquiring corporation during the 1-year period commencing with the date the qualified stock purchase was completed (the acquisition date). Nonrecognition treatment was not so limited if the acquired corporation was liquidated during such 1-year period. Nonrecognition was limited in lieu of imposing a shareholder tax on minority shareholders not disposing of their stock.

Explanation of Provision

Under the Act, the highest percentage of stock held by the acquiring corporation, for purposes of limiting nonrecognition of gain or loss, will be determined by counting increases in its stock ownership after the acquisition date only to the extent such increases are attributable to purchases, or to redemptions of the stock of the target corporation to which either (i) section 302(a) applies, or (ii) in the case of a shareholder who is not a corporation, to which sec. 301 applies. Further, under the Act, the exception to nonrecognition treatment for liquidations during the one-year period is not available if the liquidation is one to which sec. 333 applies. These restrictions are intended to limit nonrecognition of gain or loss to the acquired corporation resulting from transactions after the acquisition date to cases in which stock held by minority shareholders is disposed of in taxable transactions.

c. Nonrecognition treatment on the sale or exchange of property in connection with certain stock purchases treated as asset acquisitions

Prior Law

Gain or loss is not recognized by a corporation on the sale or exchange of property after the adoption of a plan of complete liquidation pursuant to which its assets are all distributed within 12 months (sec. 337). Under TEFRA, these nonrecognition rules apply to the constructive sale and purchase of an acquired corporation's assets resulting from a qualified stock purchase and election. It was not clear, under prior law, whether nonrecognition treatment applied to the asset sales when there was a qualified stock purchase and election with respect to an acquired corporation which had sold some of its property following adoption of a plan of liquidation.

Explanation of Provision

Under the Act, if within 12 months preceding the acquisition date of a qualified stock purchase with respect to which an election is made, the acquired corporation adopted a plan of complete liquidation which was not rescinded as of such date, the nonrecognition rules of section 337 will apply to actual sales by the acquired corporation as though it had actually distributed all its assets in liquidation on the acquisition date. The same percentage of gain or loss will be recognized to the acquired corporation with respect to these sales as will be recognized on the deemed sale of its remaining assets resulting from the election. The sale of stock and the deemed distribution will have the same effect as an actual sale of its assets by the acquired corporation to the acquiring corporation followed by a distribution in complete liquidation in applying the provisions providing exclusion from collapsible corporation treatment with respect to sales and exchanges and distributions by the acquired corporation (secs. 341(e)(1), (e)(2) and (e)(4)) and the use of the installment method by shareholders of the acquired corporation (sec. 453(h)).

d. Application of collapsible corporation treatment after stock purchase treated as asset purchase

Prior Law

Shareholders of a collapsible corporation may be required to recognize ordinary income rather than capital gain on the disposition of their stock (sec. 341). A collapsible corporation is a corporation formed or availed of to enable its shareholders to obtain capital gain treatment attributable to property produced by certain corporate activities before a substantial portion [4] of the taxable income from such property is realized by the corporation. When a qualified stock purchase of a collapsible corporation takes place, an election may be made to treat the acquisition as a purchase of assets. However, stock may continue to be owned by minority shareholders after the acquisition date of a qualified stock purchase. Collapsible corporation treatment does not apply to a stock disposition if the corporation has realized the taxable gain from the property. However, the section 338 election may eliminate the potential gain, including that attributable to minority owned shares that are purchased by the acquiring corporation, or acquired in certain redemptions, within the 1-year period following the acquisition date.

Explanation of Provision

The Act provides that the election under section 338 to treat a qualified stock purchase of a collapsible corporation as an asset purchase will be disregarded for purposes of determining whether the collapsible corporation rules apply to a disposition of stock by a minority shareholder within the 1-year period following the acquisition date.

e. Fair market value as deemed sale price in certain stock purchases treated as asset acquisitions; combined deemed sale return

Prior Law

Under TEFRA, the price at which an acquired corporation's assets were treated as sold and purchased when an election was made with respect to a qualified stock purchase was the basis of the purchasing corporation's stock in the acquired corporaton on the acquisition date, properly adjusted for liabilities and other items. For this purpose, the purchasing corporation's basis, if it owned less than 100 percent of the acquired corporation's stock, was "grossed up" to reflect 100 percent ownership. It was intended to measure the deemed sale price for recapture purposes in a manner similar to that applicable under the law prior to TEFRA when an acquired subsidiary corporation was liquidated pursuant to a plan of liquidation adopted within 2 years following a qualified purchase of the subsidiary's stock, i.e., with reference to the fair market value of the acquired corporation's assets. However, the price paid for the stock of the acquired corporation may differ from the fair market value of its net assets to take account, for example, of differing markets for stock and asset sales. Thus, it was not clear in all cases that a comparable result could be obtained under the adjusted stock basis formula prescribed under TEFRA for determining the deemed purchase price of the acquired corporation's assets.

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[4] The "substantial portion" test was changed by the Act. (See section 65.)

A target corporation with respect to the deemed sale of its assets, except as regulations may provide, was not treated as a member of an affiliated group. Thus, prior law did not provide for combining the taxable incomes, loss carryforwards and other items when elections were made with respect to two or more subsidiary corporations purchased from the same consolidated return group.

Explanation of Provision

Under the Act, in order to provide recapture and other taxable treatment comparable to that applicable when a purchased subsidiary was liquidated and the transaction was thereby treated as an acquisition of assets under prior law, the deemed sale price of the acquired corporation's assets will be their fair market value as of the acquisition date. Such fair market value may be evidenced by proper appraisals. As an alternative, under the Act, the deemed sale price of the target corporation's assets may be determined in a manner to be prescribed by regulations. It is contemplated, for example, that the regulations may provide the determination of fair market value using an elective formula which takes into account liabilities (including recapture taxes) and other relevant items. Under either approach, there was no intention to change the treatment under prior law of contingent payments and liabilities.

Under the Act, the deemed purchase price to be used in determining the basis of the target corporation's assets is the grossed-up basis of the target corporation's stock purchased by the purchasing corporation during so much of the acquisition period as ends on the acquisition date plus its basis in other target corporation stock which it owns on the acquisition date. As under prior law, adjustments are to be made under regulations for target corporation liabilities (including any recapture taxes) and other relevant items. The grossed-up basis of the purchased stock is determined by multiplying the basis (before grossing up) of such stock by a fraction, the numerator of which is the percentage by value of the target corporation's outstanding stock represented by such purchased stock plus stock not owned by the purchasing corporation, and the denominator of which is the percentage by value of such purchased stock. The total basis, as under prior law, is to be allocated among the target corporation's assets under regulations.

An election is provided under the Act pursuant to which the deemed purchase price of the target corporation's assets may be determined by stepping up the basis of the target corporation's stock held by the purchasing corporation that was not purchased during the acquisition period. The stepped-up basis is to be determined under regulations and is applicable if the purchasing corporation elects to recognize gain as if the stock were sold on the acquisition date. The deemed sale price and basis of such stock is the amount determined by multiplying the grossed-up basis of the stock purchased during so much of the acquisition period as ends on the acquisition date by a fraction, the numerator of which is the percentage by value of the target corporation's stock represented by such stock held but not purchased by the purchasing corporation during so much of the acquisition period as ends on the acquisition date and the denominator of which is the percentage by value of all the remaining target corporation stock.

Thus, for example, assume that the purchasing corporation purchases 80 percent of the target corporation's stock for $8 million during the 12-month acquisition period, that it held an addition 8 percent of the stock with a basis of $200,000 on the acquisition date, and that 12 percent of the stock was not held by the acquiring corporation on the acquisition date. Assume that there are no liabilities (including recapture liabilities). Under the Act, the target corporation's basis in its assets will be $9.4 million (92%/80% times $8 million (i.e., $9.2 million) plus $200,000). The purchasing corporation may elect to treat the 8 percent stock as sold for $800,000 ($9.2 million multiplied by the fraction 8 percent over 92 percent). If the election is made, the purchasing corporation will recognize gain of $600,000 and then the target corporation will have a basis in its assets of $10 million.

Under the Act, a combined return may be filed where an election applies to 2 or more target corporations purchased from a group which files a consolidated return for the taxable period in which the transaction occurs. The combined return will include the combined taxable income attributable to the deemed asset sales by, and any loss carryovers of, the target corporations.

f. Period for making election in connection with certain stock purchases treated as asset acquisitions; estimated tax penalty inapplicable

Prior Law

An election following a qualified stock purchase must have been made, except as regulations provide otherwise, within 75 days after the acquisition date. However, as amended by the Technical Corrections Act of 1982, transitional rules permitted an election, or revocation of a previous election by February 28, 1983. This transitional rule included purchases made before September 1, 1982.

Section 6655 imposes an addition to the tax for failure of a corporation to timely pay its estimated tax liability.

Explanation of Provision

Under the Act, the election may be made not later than the fifteenth day of the ninth month following the month in which the acquisition date occurs, except as regulations provide otherwise.

Tax attributable to the deemed sale resulting from the election will not be taken into account for purposes of the addition to tax under section 6655.

Further, it is intended, if the target corporation fails to file the return or pay the tax resulting from the election by the date prescribed for such a filing or payment, that generally the failure will be deemed to be due to reasonable cause and not due to willful neglect in determining the applicability of any addition to tax as a result of such failure, providing a return is filed and the tax is paid by the date for making the election.

The Act allows until 60 days after the date of enactment to make an election with respect to acquisitions made before September 1, 1982.

g. Exceptions to the deemed election rule

Prior Law

Exceptions to the deemed election treatment were made for acquisitions in the ordinary course of the target corporation's trade or business, acquisitions before September 1982, acquisitions of property the basis of which is determined in whole or in part by reference to its basis to the transferor, acquisitions of property located outside the United States to the extent provided in regulations, and other acquisitions described in regulations.

Explanation of Provision

The Act modifies the carryover basis exception by requiring the basis of the acquired property to be determined wholly by reference to its basis to the transferor in order to qualify for this exception.

The Act clarifies the scope of the prior law regulatory authority under section 338(e)(2) by specifically providing that conditions may be imposed by the regulations in order to come within the scope of this exception. It is contemplated, for example, that the regulations may provide an exception to deemed election treatment if the purchasing corporation elects, with respect to property acquired from the target corporation or a target affiliate during the consistency period, to take as its basis in the acquired property the adjusted basis of the property in the hands of the person from whom acquired rather than its cost. It is contemplated that a carryover basis will not apply to any item of property if the result would be a basis to the purchasing corporation in excess of the cost of such item to the purchasing corporation. A corporation making this election will be bound by all of the terms and conditions prescribed in the regulations, notwithstanding any other provision of the Internal Revenue Code. The Act eliminated the separate regulatory exception for acquisitions of property located outside the United States.

h. Treatment of certain liquidations for tax avoidance purposes

Prior Law

Generally on a complete liquidation of a controlled subsidiary, the acquiring corporation succeeds to its tax attributes, including net operating loss carryovers and other carryover items. Prior to TEFRA, when an acquired subsidiary corporation was liquidated pursuant to a plan of liquidation adopted within two years following a qualifying purchase of the subsidiary's stock, the transaction was treated as a purchase of the subsidiary's assets and its net operating loss and other carryover items and other tax attributes were terminated.

Under the TEFRA revision of prior law, the treatment of a qualified stock purchase as an asset acquisition applies on the acquisition date without liquidating the acquired corporation if an election to so treat the purchase is made by the purchasing corporation. If no election is made, the acquired corporation may be immediately liquidated following its acquisition and the acquiring corporation will succeed to its tax attributes (subject to otherwise applicable limitations). When control of a corporation is acquired, or a corporation acquires from another corporation not controlled by the acquiring corporation or its shareholders property with a carryover basis, carryovers and other tax benefits may be disallowed if the principal purpose of the acquisition is tax avoidance or evasion. The application of this disallowance provision was not clear when a purchased subsidiary corporation with unexpired carryforward items was liquidated into the acquiring corporation.

Explanation of Provision

The Act clarifies that the disallowance rule of section 269 applies when a purchased subsidiary corporation is liquidated into the acquiring corporation by providing an explicit rule to authorize the disallowance of carryover and other tax benefits of a subsidiary corporation, acquired in a qualified stock purchase with respect to which an election of asset acquisition treatment is not made, if the subsidiary corporation is liquidated pursuant to a plan adopted within two years of the acquisition date and the principal purpose of the liquidation is tax avoidance or evasion. Further, as in Treasury regulation section 1.269-3(b)(1), it is expected regulations will provide that, in the absence of evidence to the contrary, this situation is ordinarily indicative that the principal purpose of the liquidation is tax avoidance.

These rules will not cause the disallowance of loss carryover deductions and other tax benefits of a corporation because of its qualified stock purchase and liquidation of a profitable corporation without a section 338 election, where the transaction results in no change in ownership of the purchasing corporation.

This provision will apply to liquidations made after October 20, 1983.

i. Regulatory authority revised to exclude reference to target corporation and target affiliates and to provide authority to coordinate the rules relating to foreign corporations and their shareholders with the rules applicable to an asset acquisition election

Prior Law

Prior law authorized regulations to prevent circumvention (through the use of any provision or law or regulations, including the consolidated return regulations) of the requirement of consistency of treatment of stock and asset purchases with respect to a target corporation and its target affiliates.

Under prior law, when an asset acquisition election was made with respect to a qualified stock purchase involving a foreign corporation that was either a target or a target affiliate, the tax treatment of the foreign corporation and its shareholders could result in the avoidance or improper taxation of the previously untaxed earnings and profits of the foreign corporation.

Explanation of Provision

The regulatory authority under prior law is amended to delete the reference to the target corporation and its target affiliates and to apply such authority to certain sales to a single purchasing group.

The Act also provides for the issuance of such regulations as may be appropriate or necessary to provide for coordination of the rules applicable to an asset acquisition election with respect to a qualified stock purchase of a foreign corporation with the rules relating to foreign corporations and their shareholders. It is intended that regulations will prevent an asset acquisition election from having the unintended effect of allowing United States shareholders to avoid U.S. tax on certain earnings or of improperly taxing such earnings.

11. Treatment of Certain Holding Companies (sec. 712(l) of the Act and secs. 304 and 306 of the Code)

a. Amount constituting a dividend in certain redemptions through related corporations

Prior Law

If one or more shareholders with 50 percent or greater stock ownership in one corporation transfer stock of that corporation to another corporation (acquiring corporation) in which they have 50 percent or greater stock ownership in exchange for property, the transaction is treated as a dividend to the shareholders if it would be so treated by applying the redemption provisions (sec. 302) with reference to the ownership of the corporation whose stock is surrendered in the transaction (issuing corporation). Under the TEFRA revision of these provisions, if the transfer was stock of a brother corporation for a sister corporation, the determination of the amount which is a dividend was made as if the property were distributed from the issuing corporation to the acquiring corporation and then from the acquiring corporation to the shareholder. If the transfer was stock of a parent corporation to a subsidiary corporation, the determination of the amount which is a dividend was made as if the property were distributed by the acquiring corporation to the issuing corporation and then from the issuing corporation to the shareholder.

Hypothetical distributions to the acquiring or issuing corporation for the purpose of determining the amount of a dividend to the selling shareholder have been considered not to affect the taxable status of the putative distributee corporation. *Broadview Lumber Co.* v. *U.S.* 561 F. 2d 698 (7th Cir., 1977). However, the effect of such distributions on the earnings and profits of the corporation deemed to have made the distribution was unclear. If the earnings and profits were reduced, a corporation could shift earnings and profits from one member of a controlled group to another at the cost of the tax, if any, on intercorporate dividends (at most, 6.9%) and create an opportunity for the deemed distributor to make nondividend distributions to noncorporate shareholders. If a corporation sold stock in a foreign subsidiary to a domestic subsidiary, it could have been argued that the effect of these rules was to characterize the distribution as a U.S. source dividend from the domestic subsidiary whereas gain from the sale would have been treated as a dividend from the foreign corporation's earnings and profits if section 304 were inapplicable. In other cases, the application of the foreign tax credit was unclear with respect to a dividend resulting from the application of section 304 to a sale of stock in a foreign corporation to a related corporation in cases where there would be a foreign tax credit under section 902 if the issuing corporation paid a dividend directly to the U.S. selling corporation.

Explanation of Provision

To address these issues, the Act revises the deemed distribution rules of section 304 to provide that in all cases, i.e., both brother-sister and parent-subsidiary transactions, the characterization of a distribution as a dividend, and the source of the dividend will be determined by treating the distribution as made by the acquiring corporation directly to the selling shareholder to the extent of the earnings and profits of the acquiring corporation and then as made by the issuing corporation directly to the selling shareholder to the extent of its earnings and profits. Thus, any dividend received deduction or foreign tax credit will be allowed to the same extent as if the distribution had been made directly by the corporation which is treated as having made the distribution. Also, the earnings and profits of the corporation which is treated as having made a distribution will be reduced.

This provision will apply to transfers after June 18, 1984, unless the taxpayer elects to have the provisions apply as if enacted in TEFRA. Transfers to a Bank Holding Company where regulatory approval was requested on or before June 18, 1984, and the transfer is made within 90 days of final regulatory approval will be treated as a transfer on or before June 18, 1984, for this purpose.

b. Coordination of redemptions through related corporations with provisions for nonrecognition of gain or loss

Prior Law

The exchange of stock in a 50-percent or greater controlled corporation for property from another 50-percent or greater controlled corporation is treated as a stock redemption subject to dividend treatment (under sec. 304). TEFRA provided that the provision relating to transfers to 80-percent or greater controlled corporations (sec. 351) would generally not apply to the extent of the nonstock consideration distributed. However, the language also applies to exchanges governed by the corporate reorganization provisions. Further, redemption treatment was made inapplicable where the property received consists of indebtedness assumed by the acquiring corporation or indebtedness to which the transferred stock is subject if such indebtedness (acquisition indebtedness) was incurred by the shareholder to acquire the transferred stock. Redemption treatment was made inapplicable even if the acquisition indebtedness was assumed in a transaction to which the nonrecognition rules would not apply (one in which the transferors own less than 80 percent of the acquiring corporation). Finally, under TEFRA, stock redemption treatment did not apply to certain minority shareholders who receive securities in an exchange in which stock in a bank is transferred to a newly formed bank holding company provided those who receive property in the exchange do not have control of the bank holding company.

Explanation of Provision

The Act clarifies that only the nonrecognition provision governing transfers to a corporation in which the shareholders have 80 percent or greater control (sec. 351) would be made inapplicable to exchanges involving controlled corporations treated as redemptions. Thus, where the reorganization provisions apply, including those governing the treatment of exchanges by shareholders pursuant to a plan of reorganization, the rules of section 304(a) providing treatment as a stock redemption would not apply.

In order to prevent the "bail out" of earnings by purchasing stock from a related party with borrowed funds and later transferring the stock to a related corporation with the acquisition debt assumed, the Act restricts the exclusion from the rules providing stock redemption treatment for acquisition indebtedness to cases in which the indebtedness is incurred to purchase stock from a person whose stock ownership is not attributable, under section 318(a), to the person transferring the stock to the acquiring corporation. Attribution resulting from ownership of an option is to be ignored in applying this rule. An exception applies where the related person terminates its interest in the issuing and acquiring corporations, does not acquire (other than by reason of death) an additional interest in either corporation for ten years, and files an agreement with the Secretary similar to the agreement now required under the regulations under section 302(c)(2). Until additional regulations are promulgated for purposes of this new provision, agreements complying generally with the present requirements will suffice.

Finally, the Act provides that where the shareholders receive property consisting of the assumption of acquisition indebtedness in a corporation in which their control is between 50 and 80 percent, the transaction will be subject to redemption and possible dividend treatment under section 304(a).

The related party acquisition debt rule will apply to transfers after June 18, 1984, unless the taxpayer elects to have the provision apply as if enacted in TEFRA. Transfers to a Bank Holding Company where regulatory approval was requested on or before June 18, 1984, and the transfer is made within 90 days of final regulatory approval will be treated as a transfer on or before June 18, 1984, for this purpose. In the case of a transfer to which section 351 does not apply, the acquisition indebtedness rule in the Act will apply if the debt was incurred after October 20, 1983.

The Act clarifies that the assumption by a bank holding company of acquisition indebtedness will not be treated as property received by shareholders in control of the bank holding company for purposes of applying the rule excluding securities received by minority shareholders from the stock redemption rules. Thus the minority shareholders will not be subject to dividend treatment on the receipt of the securities.

c. Modification of constructive ownership rules in applying rules governing redemptions through use of related corporations

Prior Law

Under the constructive ownership rules, generally a shareholder is treated as owning stock held by a corporation only if the shareholder directly or indirectly owns 50 percent or more in value of the stock of such corporation and only in proportion to his ownership in the corporation. Conversely, a corporation is generally treated as owning all the stock that is held by persons who are 50 percent or greater shareholders in the corporation. In applying the rules requiring redemption treatment for exchanges of stock for property involving commonly controlled corporations, these 50-percent threshold limitations on attribution of ownership do not apply. As a result, the stock redemption rules may apply when, for example, a corporation sells stock of a subsidiary to a subsidiary of another corporation if a person owns any stock in both the parent of the purchasing corporation and the selling corporation, even though such stock in each case is merely a portfolio investment. A consequence of treating the transaction under the stock redemption rules is that, under those rules, the transferred stock is treated as a contribution to the capital of the acquiring corporation. Concern has been expressed that this treatment precludes treatment of the stock acquisition as a purchase, thus disqualifying it as a qualified stock purchase for purposes of permitting elective asset acquisition treatment by the acquiring corporation (under section 338).

Explanation of Provision

The Act provides a *de minimis* rule that constructive ownership will not apply to and from a corporation and a shareholder owning less than 5 percent in value of the stock of the corporation, for purposes of determining whether or not control exists under section 304. Further, under the Act, where the stock owned by or for a shareholder is less than 50 percent in value of the corporation's stock, attribution of ownership from the shareholder to the corporation is limited to the proportion of the value of the corporation's outstanding stock owned by the shareholder. The Act conforms the analogous constructive ownership rule applicable to the receipt of preferred stock in certain transfers of stock to controlled corporations.

d. Disposition of certain preferred stock

Prior Law

If, in lieu of the receipt of cash or other property, shareholders who transfer stock in a controlled corporation to another controlled corporation receive in exchange preferred stock in a transaction in which gain or loss is not recognized, subsequent disposition of the preferred stock may result in ordinary income to the shareholders, if receipt of cash in lieu of stock would have been treated as a dividend. The determination of the character of the hypothetical receipt of cash is made under the rules providing for stock redemption and possible dividend treatment when stock is sold to a commonly controlled corporation. This extension of the treatment generally applicable to preferred stock dividends to preferred stock received in an exchange with a controlled corporation to which the nonrecognition rules apply was adopted by TEFRA. However, the preferred stock affected by this rule may be disposed of in a stock redemption; whether ordinary income results from such redemption is determined by treating it solely as a distribution by the acquiring corporation. The acquiring corporation may be a corporation newly formed or may have little or no earnings and profits so that the distribution would not constitute a dividend.

Explanation of Provision

The Act provides that the dividend equivalence test applied with respect to a hypothetical distribution of cash will be applicable at the time of redemption or other disposition of the preferred stock (or stock whose basis is determined by reference to the basis of the preferred stock) as well as at the time of its receipt. Under this test, treatment of the redemption of the preferred stock as a dividend to the shareholders will be determined with reference to the earnings and profits of the corporation the stock of which was acquired as well as the acquiring corporation.

12. Completed Contract Method of Accounting (sec. 712(m) of the Act and sec. 229 of TEFRA)

Prior Law

TEFRA directed the Treasury Department to modify the income tax regulations relating to accounting for long-term contracts. Subsequently, on March 14, 1983, the Treasury Department issued proposed regulations in the Federal Register with respect to accounting for long-term contracts. Those regulations proposed waiving the estimated tax payment penalties for underpayments caused by certain provisions of regulations.[5]

Explanation of Provision

The Act clarifies that the Treasury Department has the authority to waive the penalties as proposed in the regulations.

13. Targeted Jobs Tax Credit (sec. 712(n) of the Act and section 51 of the Code)

Prior Law

TEFRA added qualified summer youth employees as an additional target group the employers of whom are eligible for the target jobs credit.

Prior law was unclear as to whether a qualified summer youth or a cooperative education youth who continued to work for the

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[5] Prop. Treas. reg. sec. 1.451-3(g)(5).

same employer after the summer or the education program ends was required to submit to a second determination of economically disadvantaged status certification as a member of another target group.

Explanation of Provision

The Act provides that the original determination that a qualified summer youth or cooperative education youth is economically disadvantaged would continue to be valid with respect to the eligibility of the individual as a member of another targeted group, if the individual continues to work for the same employer.

14. Limitations on Benefits and Contributions Under Qualified Plans (sec. 713(a) of the Act and sec. 415 of the Code)

Prior Law

The Code provides overall limits on contributions and benefits under qualified plans, tax-sheltered annuities, and simplified employee pensions (SEPs) for employees of private and public employers. Under a defined benefit pension plan, before TEFRA, the inflation-adjusted 1982 limit on the annual benefit for an employee was generally the lesser of $136,425 or 100 percent of the employee's average compensation (consecutive high three years). Under a defined contribution plan, before TEFRA, the inflation-adjusted 1982 limit on the annual addition for an employee was generally the lesser of $45,475 or 25 percent of the employee's compensation for the year. The dollar limits were adjusted annually for inflation. If an employee participated in both a defined benefit and a defined contribution plan of an employer, the fraction of each separate limit used was computed and the sum of the fractions was limited to 1.4.

TEFRA generally reduced the overall limits on contributions and benefits under qualified plans, tax-sheltered annuity programs, and SEPS of private and public employers.

The dollar limit on the annual addition under defined contribution plans was decreased under TEFRA from $45,475 to $30,000, and the dollar limit on the annual benefit payable under defined benefit plans was decreased from $136,425 to $90,000. TEFRA eliminated inflation adjustments until 1986, when the limits would be adjusted for post-1984 inflation. In addition, for participants covered by both a defined contribution plan and a defined benefit plan of the same employer, the limit on the sum of the fractions of the separate limits used by each plan was reduced to the lesser of 1.25 (as applied only to the dollar limits) or 1.4 (as applied to the percentage-of-compensation limits).

Under TEFRA, if retirement benefits provided by a qualified defined benefit pension plan began before age 62, the benefit limit generally was reduced so that it was the actuarial equivalent of an annual benefit of $90,000 beginning at age 62. Similarly, if retirement benefits under a defined benefit plan began after age 65, the benefit limit was increased so that it was the actuarial equivalent of an annual benefit of $90,000 beginning at age 65.

The TEFRA provision reducing the limits on contributions and benefits was generally effective for years ending after July 1, 1982.

For plans in existence on July 1, 1982, however, the provision was effective for years beginning after December 31, 1982. A special effective date was provided for plans maintained on the date of enactment (September 3, 1982) pursuant to one or more collective bargaining agreements between employee representatives and one or more employers.

Special transition rules were provided in connection with the reduced limits. Under TEFRA, a participant's current accrued benefit under a defined benefit pension plan was not reduced merely because TEFRA reduced the dollar limits on benefits payable under the plan. An individual's current accrued benefit was the benefit accrued as of the close of the last year beginning before January 1, 1983. No changes in the terms and conditions of the plan after July 1, 1982, were taken into account in determining the current accrued benefit under the special transition rules.

TEFRA also provided a special, elective transitional rule for computing the defined contribution fraction in situations in which the employer maintained both a defined contribution plan and a defined benefit plan.

Explanation of Provision

The Act clarifies that the actuarial adjustments required by TEFRA for benefits paid prior to age 62 or after age 65 are applied to the dollar limit on annual benefits ($90,000) rather than to the benefit.

In the case of a participant in a collectively bargained plan in existence on the date of TEFRA's enactment (September 3, 1982), the Act provides that the current accrued benefit is the individual's accrued benefit as of the close of the last year beginning before the earlier of (1) the date on which the last of the collective bargaining agreements terminates or (2) January 1, 1986. In addition, the Act provides that, in the case of a collectively bargained plan, changes in the terms and conditions of the plan made pursuant to a collective bargaining agreement reached prior to July 1, 1982, and ratified prior to September 3, 1982, may be taken into account for purposes of computing the current accrued benefit.

The Act clarifies that the special, elective transition rule for computing the defined contribution plan fraction is available only for plans that were in existence on or before July 1, 1982.

15. Loans to Plan Participants (sec. 713(b) of the Act and sec. 72 of the Code)

Prior Law

TEFRA provided that any amount received (directly or indirectly) by a participant as a loan from (1) a qualified plan, (2) a governmental plan (whether or not a qualified plan), or (3) a tax-sheltered annuity contract was treated as a distribution to the participant unless certain requirements were met. For example, a loan that, by its terms, must be repaid within five years generally was not treated as a distribution if the amount of the loan, when added to the outstanding loan balance (principal plus interest) with respect to the employee under all plans of the employer, did not exceed the lesser of (1) $50,000, or (2) 50 percent of the present value of the employee's nonforfeitable accrued benefit under such plan (but not less than $10,000).

TEFRA did not repeal a provision of prior law under which the repayment of a loan from an H.R. 10 plan (a qualified plan covering a self-employed individual) by an owner-employee (a sole proprietor or an individual partner who owns more than 10 percent of a partnership) was treated as a contribution to the plan. Amounts treated as contributions under the rule were subject to the limit on deductions for contributions to H.R. 10 plans.

The TEFRA loan rules generally applied to loans made after August 13, 1982. Under a special transitional rule, however, a qualified refunding loan made after August 13, 1982, and before August 14, 1983, to the extent repaid before August 13, 1983, generally was not treated as a distribution on the date of the loan. A qualified refunding loan was a loan used to make a required principal payment on a loan that was outstanding on August 13, 1982, if that payment was required to be made before August 14, 1983.

Explanation of Provision

The Act clarifies that the 50-percent loan limit does not reduce the overall limit on loans below $10,000. Accordingly if, immediately after a loan, the outstanding loan balance does not exceed $10,000, the TEFRA loan rules would not cause the loan to be treated as a distribution even though the outstanding loan balance at that time exceeds 50 percent of the employee's nonforfeitable accrued benefit under the plan.

In addition, the Act provides that a loan to an employee derived from deductible employee contributions is treated as a distribution under the plan, regardless of the amount of the loan. The present value of an employee's nonforfeitable accrued benefit under the plan does not include any accrued benefit attributable to deductible employee contributions.

The Act repeals the provision that treats a repayment of a loan to an owner-employee as a contribution to the plan on behalf of the owner-employee.

Further, the Act clarifies the special transitional rule for qualified refunding loans by defining a required principal payment to include an amount paid under a loan payable on demand if the loan was outstanding on August 13, 1982.

16. Repeal of Special Qualification Requirements (sec. 713(c) of the Act and secs. 72 and 402 of the Code)

Prior Law

TEFRA generally eliminated distinctions in the tax law between qualified plans of corporations and those of self-employed individuals (H.R. 10 plans). TEFRA (1) repealed certain of the special rules for H.R. 10 plans, (2) extended other of the special rules to all qualified plans, including those maintained by corporate employers, and (3) generally applied the remainder of the special rules, with modifications, only to those plans (whether maintained by a corporate or noncorporate employer) that favor the employer's key employees (i.e., top-heavy plans).

TEFRA provided that a distribution to an individual who is (or was) a key employee and who has not attained age 59 1/2 or become disabled was subject to an additional 10-percent income tax. This additional tax was imposed on the portion of a distribution includible in gross income and attributable to benefits accruing when the individual was a key employee in a top-heavy plan.

Explanation of Provision

The Act clarifies that, for years beginning in 1984, the additional 10-percent income tax on a distribution prior to age 59 1/2 is not to apply to a distribution to an owner-employee unless the distribution is attributable to contributions made on behalf of the individual while a key employee in a top-heavy plan.

The Act amends the rules relating to qualifying rollover distributions to provide that a rollover to a qualified plan is not permitted if any part of the distribution of a benefit is attributable to contributions made on behalf of the employee while a key employee in a top-heavy plan. If a distribution to a self-employed individual is not attributable to benefits accruing while the individual was a key employee in a top-heavy plan, a rollover to a qualified plan or a qualified annuity plan is permitted.

17. Repeal of Special Limitations on Deductions for Self-employed Individuals and Subchapter S Corporations (sec. 713(d) of the Act and secs. 72, 219, 401, 404, and 415 of the Code)

Prior Law

TEFRA generally repealed most of the special deduction limits for contributions on behalf of a self-employed individual under a qualified defined contribution H.R. 10 plan, effective for taxable years beginning after December 31, 1983. In addition, TEFRA revised the definition of earned income of a self-employed individual so that the amount of earned income corresponds to the amount of compensation of a common-law employee. Under TEFRA, in applying the rules relating to deductions and limitations under qualified plans, the earned income of a self-employed individual was computed after taking into account contributions by the employer to a qualified plan to the extent a deduction was allowed for the contributions.

TEFRA repealed the special rules applicable to qualified defined benefit pension plans providing benefits for a self-employed individual or shareholder-employee of a subchapter S corporation, effective for years beginning after December 31, 1983.

TEFRA revised the dollar limit ($30,000 for 1984) on employer contributions to a simplified employee pension (SEP) to correspond to the dollar limit on annual additions under a qualified defined contribution plan. TEFRA, however, did not increase the limit on employee deductions ($15,000) to conform with the higher limit on employer contributions.

Explanation of Provision

The Act provides that, solely for purposes of determining the extent to which contributions made to a qualified plan on behalf of a self-employed individual are ordinary and necessary for purposes of the deduction rules (sec. 404), the earned income of the self-employed individual is determined without regard to the deductions allowable for contributions to a qualified plan.[6] Of course, the amendment is not intended to change the TEFRA definition of earned income for purposes of the 15- or 25-percent limits on deductions (sec. 404).

The Act amends the effective date of the repeal of the special deduction rules for a qualified defined contribution plan which covers a self-employed individual, to clarify that the rules do not apply to a qualified defined benefit plan which covers a self-employed individual.

The Act amends the limit on a deduction by employees for employer contributions to SEPs to conform with the dollar limit on annual additions to a qualified defined contribution plan. Accordingly, the Act raises the current dollar limit on such employee deductions to $30,000.

The Act also repeals the following provisions relating to self-employed individuals:

(1) the rule relating to the return of excess contributions made on behalf of a self-employed individual prior to the due date of the annual return;

(2) the special limit on contributions by an employer on behalf of an owner-employee to pay premiums or other consideration for an annuity, endowment, or life insurance contract on the life of the owner-employee issued under an H.R. 10 plan;

(3) certain special deduction rules applicable to plans benefiting self-employed individuals or shareholder-employees; and

(4) the special limitation applicable to certain level premium annuity contracts under plans benefiting owner-employees.

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[6] The amendment made by Act section 713(d)(6) to Code section 404(a)(8) should have amended subparagraph (C) rather than subparagraph (D). A technical correction is anticipated.

18. Allowance of Exclusion of Death Benefit for Self-employed Individuals (sec. 713(e) of the Act and sec. 101 of the Code)

Prior Law

TEFRA provided that the exclusion from gross income of amount received as a death benefit by the beneficiary or estate of an employee was available with respect to any lump sum distribution under a qualified plan, a qualified annuity plan, or a tax-sheltered annuity paid on behalf of a self-employed individual.

Explanation of Provision

The Act provides that the exclusion from gross income of employee death benefits provided on behalf of a self-employed individual generally applies to amounts paid or distributed under a qualified plan. The Act does not change the rule providing that the exclusion is not available if (1) the employee (or self-employed individual) possessed, immediately before death, a nonforfeitable right to receive the amounts while living, and (2) the distribution is not a lump sum distribution.

19. Special Rules for Top-heavy Plans (sec. 713(f) of the Act and secs. 408 and 416 of the Code)

Prior Law

TEFRA provided additional qualification requirements for plans that favored an employer's key employees (top-heavy plans). These additional requirements (1) limited the amount of a participant's compensation that could be taken into account, (2) provided greater portability of plan benefits for plan participants by requiring more rapid vesting, (3) provided minimum nonintegrated contributions or benefits for plan participants who were not key employees and (4) reduced the aggregate limit on contributions and benefits for certain key employees.

An individual was a key employee of an employer if the individual was a participant in an employer plan and, at any time during the plan year or any of the four preceding plan years, (1) was an officer, (2) was one of the 10 employees owning the largest interests in the employer, (3) owned more than a 5-percent interest in the employer, or (4) owned more than a 1-percent interest in the employer and had compensation from the employer in excess of $150,000.

For any plan year for which a plan is a top-heavy plan, only the first $200,000 of any employee's compensation may be taken into account under the plan. Beginning in 1986, this $200,000 limit would have been adjusted for inflation in the same manner applicable to the adjustment of the overall dollar limits on contributions and benefits under qualified pension plans (sec. 415).

Under TEFRA, a defined benefit pension plan is a top-heavy plan for a plan year if, as of the determination date, the present value of the cumulative accrued benefits for participants who are key employees for the plan year exceeds 60 percent of the present value of the cumulative accrued benefits for all employees under the plan. A defined contribution plan is a top-heavy plan for a plan year if, as of the determination date, the sum of the account balances of participants who are key employees for the plan year exceeds 60 percent of the sum of the account balances of all employees under the plan.

If a plan is a member of a group of plans that is required to be aggregated for purposes of the rules for top heavy plans, the plan's status is determined by the status of the group. Accordingly, if the plan is a member of a group that is not top heavy, no plan in the group is top heavy even though a particular plan, standing alone, would be top heavy. Similarly, if the group is top heavy, each plan in the required aggregation group is top heavy even though the particular plan, standing alone, is not top heavy.

Under a 5-year lookback rule, the present value of the cumulative accrued benefit of a participant in a defined benefit pension plan or the account balance of a participant in a defined contribution plan generally includes any amount distributed with respect to the participant under the plan within the five-year period ending on the determination date (including lump-sum distributions and distributions made before the date of enactment or before the plan became top-heavy).

Explanation of Provision

The Act revises the definition of a key employee to include any employee, rather than any participant in an employer plan, who has the requisite relationship to the employer. An employee includes a former employee who must be considered under the five-year lookback rule. In addition, the Act provides that (1) an employee is not included as a key employee by reason of the top-ten employee owner rule unless that employee's compensation exceeds the dollar limit for the year on annual additions to qualified defined contribution plans ($30,000 for 1984); and (2) under the top-ten employee owner rule, if two employees have the same interest in the employer, the employee with greater annual compensation is treated as having a larger interest. For purposes of determining which key employees have greater compensation, in the case of a key employee who no longer performs services for the employer, the employee is treated as having compensation equal to the employee's compensation in the last one-year period in which services were performed. Further, the Act clarifies that the determination of the amount of an employee's interest in an employer for purposes of determining the top-ten owners, 5-percent owners, or 1-percent owners is determined without regard to the aggregation rules of sections 414(b), (c), or (m).

Under the Act, the requirement that the employer make a minimum contribution on behalf of each participant who is not a key employee applies to a SEP if the SEP arrangement is top-heavy.

The Act clarifies that distributions under a terminated plan are taken into account under the 5-year lookback rule in determining the top-heavy status of plans maintained by an employer.

The Act provides that the $200,000 limit on compensation taken into account under SEPs will be adjusted for inflation at the same time and in the same manner as the adjustments to the overall dollar limit on annual additions under a qualified defined contribution plan. In addition, the Act clarifies that no adjustment will be made to the $200,000 limit on compensation taken into account under the rules for top-heavy plans until adjustments are made to the overall dollar limits on contributions and benefits.

20. Required Distributions in Case of Individual Retirement Plans (sec. 713(g) of the Act and sec. 408 of the Code)

Prior Law

TEFRA revised the rules relating to distributions from an individual retirement account or annuity (IRA) after the death of the individual on whose behalf the IRA was established. In addition, TEFRA repealed the rules under which any beneficiary of an individual on whose behalf an IRA was established (or any beneficiary of the surviving spouse of such an individual) effectively could elect to treat the inherited IRA as one established on the beneficiary's own behalf.

The TEFRA provision relating to the treatment of inherited IRAs was effective for taxable years beginning after December 31, 1983.

Explanation of Provision

The Act clarifies that the provision applies with respect to individuals dying after December 31, 1983.

21. Existing Personal Service Corporations Liquidating in 1983 or 1984 (sec. 713(h) of the Act and sec. 247 of TEFRA)

Prior Law

TEFRA provided a transitional rule under which personal service corporations could, during 1983 or 1984, complete a one-month liquidation under section 333 without the corporation incurring tax on its unrealized receivables.

Explanation of Provision

The Act clarifies that this transition rule is available only to corporations that were in existence on September 3, 1982 (the date of enactment of TEFRA).

22. Employee Leasing (sec. 713(i) of the Act and sec. 414 of the Code)

Prior Law

For purposes of certain of the tax-law rules for qualified plans and SEPs, an individual (a leased employee) who performs services for another person (the recipient) is treated as the recipient's employee if the services are performed pursuant to an agreement between the recipient and a third person (the leasing organization) who is otherwise treated as the individual's employer. The individual is treated as the recipient's employee only if the individual has performed services for the recipient (or for the recipient and persons related to the recipient) on a substantially full-time basis for a period of at least 12 months, and if the services are of a type historically performed by employees in the recipient's business field. However, under a safe-harbor provision, an individual who otherwise would be treated as a recipient's employee pursuant to these rules is not treated as such an employee, if certain requirements are met with respect to contributions provided for the individual under a qualified money purchase pension plan maintained by the leasing organization.

Explanation of Provision

The Act clarifies the prior law definition of a leased employee by providing that an employee of the recipient is not to be treated as a leased employee with respect to the recipient. Thus, the safe-harbor rule (sec. 414(n)(7)) is inapplicable to a leased employee who is otherwise a common law employee of the recipient. Neither the Act nor TEFRA modified the common-law status of employees of a recipient.

23. Nondiscriminatory Coordination of Defined Contribution Plans With OASDI (sec. 713(j) of the Act and sec. 408 of the Code)

Prior Law

TEFRA extended to all qualified defined contribution plans a prior-law rule for qualified H.R. 10 plans under which the tax rate and wage base applicable to employers for old age, survivors, and disability insurance (OASDI) under social security are the maximum rate and base for determining the amount by which employer contributions can be reduced under qualified plans that are integrated with social security.

Explanation of Provision

The Act provides that, if an employer does not maintain an integrated plan at any time during the taxable year, OASDI contributions may be taken into account as contributions by the employer to an employee's simplified employee pension (SEP). This rule applies, however, only if OASDI contributions are taken into account with respect to each employee maintaining a SEP.

24. Profit-sharing Plan Contributions on Behalf of Disabled Employees (sec. 713(k) of the Act and sec. 415 of the Code)

Prior Law

TEFRA permitted an employer to elect to continue deductible contributions to a profit-sharing plan on behalf of an employee who was permanently and totally disabled. The contributions are deductible, however, only if contributions are nonforfeitable when contributed.

Explanation of Provision

The Act clarifies that the election is available for contributions to a qualified profit-sharing and stock bonus plan. In addition, the

Act clarifies that only those contributions that are the subject of the employer's election must be nonforfeitable when made under the special rule.

25. Attorney's Fees (sec. 714(c) of the Act and sec. 7430 of the Code)

Prior Law

TEFRA added provisions allowing awards of attorney's fees to taxpayers under certain circumstances in tax cases commenced after February 28, 1983, in any United States court or the Tax Court. On October 1, 1982, (after enactment of TEFRA), the U.S. Court of Claims was reorganized, creating a new United States Claims Court as an Article I court. Because of this reorganization, the question arose whether the Claims Court was a "court of the United States" for purposes of the attorney's fee provisions.

Explanation of Provision

The Act clarifies that the attorney's fee provisions of TEFRA apply in tax cases in the Claims Court.

26. Dividend Reporting (sec. 714(d) of the Act and sec. 6042 of the Code)

Prior Law

Under prior and present law, payments of dividends and interest must generally be reported to the recipient and to the Internal Revenue Service. Under prior and present law, payments of interest to a number of recipients are, however, exempt from reporting because reporting of those payments would not be useful to the Internal Revenue Service. For example, reporting is not required where the payments generally are not taxable income to those recipients. The statutory list of recipients with respect to whom reporting of interest is not required includes corporations, tax-exempt organizations, domestic or foreign governmental units, and brokers. Prior law did not contain a similar list of recipients of dividends with respect to whom reporting need not be done.

Explanation of Provision

The Act amends section 6042 of the Code by providing that dividend payments to certain recipients are exempt from dividend reporting. Those recipients are the same as those with respect to whom payments of interest are exempt from interest reporting. The Secretary is given the authority to issue regulations to require that reports be furnished with respect to dividend payments to any of these listed entities.

27. Broker Reporting (sec. 714(e) of the Act and sec. 6045 of the Code)

Prior Law

Under prior and present law, brokers must furnish reports to the Internal Revenue Service and the taxpayer regarding the gross proceeds of transactions they complete for their customers. Under prior law, a governmental unit was not subject to broker reporting and, consequently, was not required to implement backup withholding on these broker transactions.

Explanation of Provision

The Act provides that governmental units and agencies and instrumentalities of governmental units, such as the Bureau of Public Debt, are required to file broker reports when they act as brokers. They will also be required to implement backup withholding on these broker transactions.

28. Jurisdiction of Claims Court With Respect to Tax Shelter Promoter and Understatement Penalties (sec. 714(g) of the Act and secs. 7422 of the Code and 1509 of title 28, United States Code)

Prior Law

Under prior and present law, the Internal Revenue Service can assess penalties for promoting abusive tax shelters (sec. 6700) or for aiding and abetting the understatement of tax liability (sec. 6701). Under prior and present law, the Service can also seek an injunction against a promoter of an abusive tax shelter. Under prior law, if the taxpayer against whom either penalty was assessed filed for a refund of the penalty in the Claims Court, that Court would lack jurisdiction to hear the likely counterclaim of the Government for an injunction.

Explanation of Provision

The Act deprives the Claims Court of jurisdiction over refund cases involving the tax shelter promoter penalty or the penalty for aiding and abetting the understatement of tax liability.

29. Withholding on Pensions, Annuities, and Certain Other Deferred Income (sec. 714(j) of the Act and secs. 31, 3405, and 6652 of the Code)

Prior Law

TEFRA provided that payors generally are required to withhold tax from a designated distribution (the taxable part of a payment made from or under a pension, profit-sharing, stock bonus, or annuity plan, and IRA, a commercial annuity contract, or an employer deferred compensation plan if the distribution is not otherwise considered wages). Recipients may elect, for any reason, not have the withholding rules apply to any distribution. Payors are required to notify recipients of their right to elect not to have the withholding rules apply.

Explanation of Provision

The Act provides a credit against income tax for the amounts withheld under the pension withholding provisions.

Under the Act, no amount is required to be withheld if a distribution consists only of employer securities of the employer corporation and cash in lieu of fractional shares of employer securities. The amount of cash received in the distribution may not exceed \$200. The Act clarifies that the taxable part of a nonperiodic distribution paid by reason of death under a qualified plan or a tax-sheltered annuity is determined by taking into account the \$5,000 death benefit exclusion provided in section 101(b), whether or not the exclusion is allowable.

The Act clarifies that the pension withholding rules do not apply to amounts paid to nonresident aliens if the amounts are subject to the withholding of tax on nonresident aliens or would be subject to such withholding but for a tax treaty.

Further, the Act provides a penalty for failure to give the notice to recipients required under the pension withholding rules. The penalty applies unless it is shown that the failure is due to reasonable cause and not willful neglect. The penalty is equal to \$10 for each failure, up to a maximum during any calendar year of \$5,000.

30. Interest on Tentative Carrybacks and Refund Adjustments (sec. 714(n) of the Act and secs. 6411 and 6611 of the Code)

Prior Law

In general, under present and prior law, interest on refunds, credits and offsets ran from the date of overpayment, which was usually the date prescribed for filing the particular return, to a date (in the case of a refund) preceding the date of the refund check by not more than 30 days, or (in the case of a credit) to the due date of the amount against which the credit was taken. However, when the return is late because it is filed after the due date (determined with regard to extensions) no interest is payable on the overpayment for any period prior to the date on which the return is filed.

Under TEFRA, interest on payments attributable to net operating loss carrybacks and credit carrybacks runs from the due date of the return for the year in which the loss or credit carryback arises rather than from the close of such year. If, however, the claim for refund (including an application for tentative carryback or refund adjustment) based on the carryback of the loss or credit from the loss year is filed after the due date of the return for the loss year (determined without regard to extensions), interest on the refund is payable only if the refund is not made within 45 days of the claim. If the 45-day period expires, interest runs from the due date of the return for the loss year. If the overpayment attributable to a carryback gives rise to a credit or offset (as in an inter-year adjustment made during an audit) then interest runs on the portion of the overpayment in excess of the amount credited or offset from the due date of the return for the loss year. Similarly, interest on the underpayment so credited or offset against will cease to accrue as of the filing date for the loss year.

Under prior law, some taxpayers filed an amended return claiming a refund based on a carryback, waited until the 45-day period expired, and then filed for a tentative adjustment. This enabled them to defeat the interest rules relating to tentative adjustments by obtaining interest on the tentative adjustment relating back to the due date of the return for the year of the loss.

Under prior law, a claim for a rebate (such as a tentative adjustment) was not subject to the penalty for substantial understatement of tax liability (sec. 6661).

Explanation of Provision

The Act provides that, for purposes of computing interest on refunds arising from net operating loss carrybacks where a tentative adjustment claim is filed, the refund is not treated as claimed earlier than the time the tentative adjustment is claimed. If a tentative adjustment is not claimed, interest is computed under prior law rules.

The Act also provides that for purposes of the penalty for substantial understatement of tax liability, the term understatement means the excess of the amount of the tax required to be shown on the return for the taxable year (i.e., the tax actually imposed after all adjustments and carryovers) over the amount of tax shown on the return (i.e., the tax voluntarily reported on the original return) reduced by the amount of any rebate. A rebate is an abatement, credit, refund, or other repayment made on the grounds that the tax imposed by subtitle A was less than that shown on the taxpayers refund or previously assessed and not previously rebated.

31. Partnership Audit (sec. 714(p) of the Act and sec. 6233 of the Code)

Prior Law

The tax treatment of any partnership item, under the rules adopted in TEFRA, is required to be determined at the partnership level. A comparable requirement applies in the case of subchapter S corporations. A partnership return or an S corporation may be filed for a taxable year and it may thereafter be determined that the filing entity is not a partnership or an S corporation, respectively, or that there is no entity for the taxable year with respect to which the return was filed.

Explanation of Provision

Under the Act, to the extent regulations provide, the partnership level determination requirement and the comparable requirement for S corporations apply when a partnership return or S corporation return, respectively, is filed, although it is thereafter determined that the filing entity was not a partnership or S corporation, or that no entity existed for the taxable year as to which the return was filed.

32. Estates and Trusts Required To Provide Information to Certain Beneficiaries and Shareholders (sec. 714(q) of the Act and secs. 6034A, 6037, and 6678 of the Code)

Prior Law

Under prior law, there was no specific requirement that trusts or estates furnish copies of returns to their beneficiaries or that S corporations furnish copies of returns to their shareholders.

Explanation of Provision

The Act provides that trusts and estates are required to furnish copies of returns to their beneficiaries and that S corporations are required to furnish copies of returns to their shareholders. The Act also provides a $50 penalty on trusts, estates, partnerships, and S corporations for each failure to provide a copy of their returns to beneficiaries, partners, or shareholders.

33. Clerical Amendments

Amendments are also made to correct several clerical errors and correct cross references.

B. Technical Corrections to the Subchapter S Revision Act of 1982

1. Corporate Liquidations, etc. (sec. 721(a) of the Act and sec. 1363(e) of the Code)

Prior Law

The Subchapter S Revision Act of 1982 (the "1982 Act") provided that gain is recognized on the distribution of appreciated property by an S corporation with respect to its stock. The committee reports stated that this rule did not apply in the case of a complete liquidation.

Explanation of Provision

The Act adds clarifying language making this rule inapplicable in the case of a complete liquidation of an S corporation, or to the distribution of stock by an S corporation in a reorganization where the receipt of that stock is tax-free to the shareholder (by reason of sec. 354, 355, or 356). It is intended both that a liquidating distribution by an S corporation will be a nonrecognition transaction at the corporate level, and also that the nonrecognition provisions of section 337 will continue to apply to the sale or exchange of property after a plan of complete liquidation has been adopted by an S corporation.

As under present and prior law, gain or loss will be recognized by the shareholder with respect to his or her S corporation stock on receipt of a distribution in complete liquidation (under the rules of secs. 331 or 333). The amount of gain or loss recognized to the shareholder will not be affected by any gain or loss which is not recognized at the corporate level.

2. Treatment of Discharge of Indebtedness (sec. 721(b) of the Act and sec. 108 of the Code)

Prior Law

Generally, a taxpayer realizes income when its debts are discharged at less than the face amount of the debt. However, if the debt was incurred by a corporation, the taxpayer may elect to reduce certain tax attributes in lieu of recognizing income.

Explanation of Provision

In order to treat all shareholders in the same manner, the Act provides that the exclusion of income arising from discharge of indebtedness and the corresponding reductions in tax attributes (including losses of a bankrupt or insolvent corporation which are not allowed by reason of any shareholder's basis limitation) are made at the corporate level. Also, the Act provides that where a debt is

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contributed to an S corporation by a shareholder as a contribution to capital after December 31, 1980, corporate income would not result to the extent that the basis of the debt had previously been reduced by the pass-through of losses from the corporation (under present or prior law).

3. Treatment of Inactive Subsidiaries (sec. 721(c) of the Act and sec. 1361(c)(6) of the Code)

Prior Law

Under prior law, an S corporation may not have owned a subsidiary corporation other than an inactive subsidiary. An inactive subsidiary was defined as a corporation which had not begun business before the close of the taxable year and which had no taxable income for the period included within the S corporation's taxable year.

Explanation of Provision

The Act eliminates the taxable income test and instead provides that a subchapter S election terminates, by reason of the subsidiary becoming active, on the first day during the S corporation's taxable year that the subsidiary has gross income. This rule prevents a termination of the subchapter S election from occurring retroactively to the beginning of the taxable year (which is generally prohibited) by reason of the subsidiary having any taxable income. For purposes of applying this gross income test, contributions to the corporation's capital by a shareholder are not to be treated as gross income.

4. Treatment of Worthless Debt (sec. 721(d) of the Act and sec. 1367(b) of the Code)

Prior Law

The 1982 Act provided that corporate losses which pass through to the shareholders are to be taken into account prior to taking into account the deduction for worthless stock.

Explanation of Provision

The Act provides the same rule where the shareholder's debt in the corporation becomes worthless. Thus, for example, where a shareholder has no basis in his or her S corporation stock but has basis in debt owed by the corporation and that debt becomes worthless, corporate losses for the year will be allowed to the shareholder; these losses will reduce the shareholder's basis in the debt, which in turn will reduce the amount of the short-term capital loss (under sec. 166(d)) for the worthless debt.

5. Investment Tax Credit Recapture (sec. 721(e) of the Act and sec. 1371(d) of the Code)

Prior Law

The 1982 Act provided that the recapture of the investment tax credit for credits claimed in years prior to becoming an S corporation was to be made at the corporate level.

Explanation of Provision

The Act clarifies that an S corporation's accumulated earnings and profits will be reduced by the amount of investment credit recapture tax (sec. 47) imposed on the corporation with respect to these credits, since the earnings and profits were not previously reduced by the amount of tax savings attributable to the credit.

6. Qualified Subchapter S Trusts (sec. 721(f) of the Act and sec. 1361(d) of the Code)

Prior Law

Prior law allowed certain trusts which distribute, or were required to distribute, income currently to elect to be treated as a "qualified subchapter S trust" which may be a shareholder in an S corporation. This election could be retroactive for up to 60 days.

Explanation of Provision

The Act increases this period to 2 months and 15 days, to generally conform to the time provided the corporation to make a subchapter S election.[7] Also, the Act clarifies that the disqualification of a trust by reason of the failure to meet the distribution requirements will be effective on the first day of the first taxable year after this requirement is not met.

7. Accounting Treatment Where Election Terminates (sec. 721 (g), (h) and (t) of the Act and sec. 1362 of the Code)

Prior Law

Under prior law, the items of income, loss, etc. for the entire taxable year in which a subchapter S election was terminated were pro-rated between the short subchapter S year and the short regular corporate year on a daily basis, unless all persons who were shareholders at any time during the year consented to closing the corporate books at the end of the subchapter S year.

Explanation of Provision

The Act provides that the election to "close the books" may be made only if all the shareholders owning stock during the short subchapter S year and all shareholders owning stock on the first day of the short subchapter C year consent to the election. Also, under the Act, if a corporation makes a qualified stock purchase of

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[7] See Treasury Temp. Reg. Sec. 18.1362-(b).

the stock of an S corporation and makes an election under section 338, all the recapture income resulting from the election will be reported in the corporation's subchapter C return. As a result, the selling shareholders will not take this recapture into account on their individual returns. Finally, the pro rata method will not be available if there is a sale or exchange of 50 percent or more of the corporation's stock during the year. Certain transitional rules are provided.

8. Passive Income Rules for 1982 (sec. 721(i) of the Act and sec. 6(b) of the 1982 Act)

Prior Law

Under the 1982 Act, the amendments to the passive income rules preventing a subchapter S election from terminating by reason of excess passive income for any single taxable year, were made effective for taxable years beginning after December 31, 1981.

Explanation of Provision

The Act provides that a corporation can elect to have the new passive income rules apply only for taxable years beginning after December 31, 1982, the general effective date for the Act. Thus, a corporation with excess passive income under the rules of prior law for its taxable year beginning in 1982 can elect to terminate its subchapter S election rather than paying both a corporate and shareholder tax on that income. If an election under this provision is made causing the termination of the subchapter S election, the corporation cannot re-elect subchapter S status within 5 years without the consent of the Internal Revenue Service.

9. Attribution Rules (sec. 721(j) of the Act and sec. 318 of the Code)

Prior Law

Under prior law, in applying attribution of ownership rules under section 318, a partnership was deemed to own proportionately stock owned by the partnership, and the partnership was deemed to own all the stock owned by the partners. In the case of a corporation, attribution to and from shareholders occurred only with respect to shareholders owning 50 percent or more in value of the corporation's stock.

Explanation of Provision

The Act provides that the attribution of stock to or from an S corporation and its shareholders would apply in the same manner as if the S corporation (and its shareholders) were a partnership (with partners). Thus, attribution will occur to and from shareholders owning less than 50 percent of the corporation's stock.

10. Certain Short Taxable Years (sec. 721(l) of the Act and sec. 1362(b) of the Code)

Prior Law

Under prior law, a subchapter S election for a taxable year could be made during the first 2 1/2 months of the taxable year (sec. 1362(b)(1)(B)).

Explanation of Provision

The Act provides that a corporation can make the election within 2 1/2 months from the beginning of a taxable year although the taxable year is of less than 2 1/2 months duration. The Act also clarifies that when the election for the short year is late filed but is timely for the subsequent taxable year, it may be effective for the subsequent year. This provision applies to elections made after October 19, 1982.

11. Taxable Year of Existing S Corporations (secs. 721 (m) and (q) of the Act and sec. 1378 of the Code)

Prior Law

Under prior law, an S corporation which had an election in effect for a taxable year which includes December 31, 1982, could not retain that taxable year after there has been a change in ownership of more than 50 percent of the stock after December 31, 1982. Acquisitions by reason of death, gift or certain buy-sell agreements were not treated as change in ownership.

Explanation of Provision

The Act clarifies that the ownership change rules apply to any corporation which made an election before October 19, 1982, where that election was effective for a taxable year beginning in 1983. The Act also clarifies that stock held by an estate of a decedent on December 31, 1982, may qualify as stock acquired by reason of death, for purposes of the change in ownership rules.

12. Distributions During Post-termination Period (sec. 721(o) of the Act and sec. 1371(e) of the Code)

Prior Law

Under prior law, a distribution of cash by a corporation during a period generally one year from the date an S corporation election terminates ("post-termination transition period") was tax-free to the extent of amounts in an accumulated adjustments account (generally undistributed S corporation income).

Explanation of Provision

The provision allows corporations to elect to treat distributions as dividends during this post-termination transition period. This will allow a corporation to pay dividends to avoid accumulated earnings tax or personal holding company tax.

13. Corporate Preference Items (sec. 721(p) of the Act and sec. 1363(b) of the Code)

Prior Law

Under prior law, S corporations computed their taxable income as an individual, and therefore the provision relating to corporate preference items did not apply to an S corporation.

Explanation of Provision

In order to prevent a regular corporation from avoiding the corporate preference rules by making an S corporation election, the Act provides that the corporate preference rules will apply for the first three taxable years after a regular corporation elects subchapter S status. The rules will not apply to any corporation which has been an S corporation for all its taxable years.

14. Accumulated Adjustments Account (sec. 721(r) of the Act and sec. 1368(e) of the Code)

Prior Law

Under prior law, S corporations generally could make tax-free distributions to the extent the distributions did not exceed the amount in an accumulated adjustments account. This account generally reflected the accumulated net income of the corporation less prior distributions.

Explanation of Provision

The Act provides that S corporation losses for any year may cause the account to become negative so that future income will cause the account to become positive only after the negative balance has been restored.

The Act also provides that non-deductible amounts which are not related to the production of income which is exempt from tax will reduce the amount in the account.

Finally, the Act provides that for any taxable year, except to the extent provided by regulations, the amount in the account (after taking into account income and loss for the taxable year) will be used up pro rata among all distributions made during the year. Thus, if the account balance at the end of a year, before distributions, is $100 and the corporation distributes $200 during the taxable year, one-half of each distribution will be treated as from the accumulated adjustments account and therefore will not be taxed as a dividend.

15. Waiver of Tax on Passive Income (sec. 721(u) of the Act and sec. 1375 of the Code)

Prior Law

Prior law imposed a tax on subchapter S corporations with passive income and subchapter C earnings and profits.

Explanation of Provision

Under the Act, the tax on passive income can be waived by the Internal Revenue Service if the corporation had determined, in good faith, that it had no such earnings and profits, and the earnings are distributed after their discovery.

16. Restoration of Debt Basis (sec. 721(v) of the Act and sec. 1367(b)(2) of the Code)

Prior Law

The 1982 Act required the basis of debt which was reduced by losses to be restored by subsequent income.

Explanation of Provision

The Act clarifies that basis restoration applies only to the extent the basis in the debt was reduced in taxable years beginning after 1982.

17. Clerical Amendments

The Act also makes several clerical amendments to the 1982 Act.

C. Technical Corrections to Miscellaneous Provisions

1. Tax Preference for Low-income Housing (sec. 722(a)(1) of the Act and sec. 57 of the Code)

Prior Law

The Technical Corrections Act of 1982 added a provision to clarify that the amortization of low-income housing under section 167(k) remained a tax preference, but erroneously added that provision to subparagraph (A) of section 57(a)(12).

Explanation of Provision

This Act moves that provision to subparagraph (B) of section 57(a)(12), relating to the tax preference for real property.[8]

2. Foreign Currency Contracts (sec. 722(a)(2) and (4) of the Act and sec. 1256(g) of the Code)

Prior Law

The Technical Corrections Act of 1982 provided that certain foreign currency contracts will be treated as regulated futures contracts and therefore be taxed on the marked-to-market system with a maximum tax rate of 32 percent. In order for a contract to qualify as a foreign currency contract, the contract must require delivery of a foreign currency which is a currency in which positions are also traded through regulated futures contracts.

Explanation of Provision

Because certain contracts may call for a cash settlement by reference to the value of the foreign currency rather than actual delivery of the currency, the Act provides that the delivery of a foreign currency requirement is met where the contract provides for a settlement determined by reference to the value of the foreign currency.

3. Effective Date of Corporation Acquisition Provision (sec. 722(a)(3) of the Act and sec. 306(a)(8) of TEFRA)

Prior Law

The Technical Corrections Act of 1982 clarified that any recapture income required to be reported as the result of an election to treat the purchase of corporate stock as the sale and purchase of the corporate assets generally is not reported on a consolidated

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[8] This provision was then inadvertently deleted by the revision to Code section 57(a)(12)(B) by Act section 111(e)(6). A technical correction is anticipated.

return. Instead, the income is reported on the target corporation's separate return. The new TEFRA provision allowing an election to treat stock purchases as asset purchases was effective for purchases on or after September 1, 1982. A transitional rule was provided by the Technical Corrections Act to require reporting of the recapture income on the selling corporation's consolidated return in circumstances where the contract was negotiated on the contemplation that the recapture income would be reported on the selling corporation's consolidated return, and where the stock was purchased pursuant to a binding contract entered into on or after the date of enactment of TEFRA (September 3, 1982) and before the date of enactment of the Technical Corrections Act. The transitional rule was inapplicable where the contract was entered into before September 3, 1982, notwithstanding that it was contemplated that the new TEFRA rules would apply.

Explanation of Provision

The Act makes the special transitional rule requiring recapture income to be reported on a selling corporation's consolidated return applicable to contracts entered into on or after September 1, 1982 (the effective date of the TEFRA election provision), rather than on or after September 3, 1982 (the date TEFRA was enacted into law).

4. Windfall Profit Tax (sec. 722(a)(7) of the Act and sec. 201(h) of the Technical Corrections Act of 1982)

Prior Law

The Technical Corrections Act of 1982 made changes in the rules for computing windfall profit tax liabilities when oil is produced subject to a net profits interest. The correction applied retroactively in the case of net profits interest agreements which provided that 90 percent or more of the net profit was to be received by a governmental entity or charity exempt from the windfall profit tax. (See sec. 201(h)(1)(E) of the Technical Corrections Act of 1982.)

Explanation of Provision

For periods before 1983, the Act provides a simplified procedure for the payment of refunds which arose by reason of the retroactive effective date for the 1982 technical correction relating to net profits interests (sec. 201(h)(1)(e) of the Technical Corrections Act of 1982). This procedure applies if refunds required under the correction are payable to partners of a partnership, and the partners are obligated to pay over the amount of the refund to one or more governmental units or charities (either directly or by reason of an agreement made by the partnership, including an agreement made by a limited partnership). The procedure permits the partnership to be treated as authorized to act for each person who was a partner at any time in such partnership for purposes of claiming and paying over the refund.

The Act provides a period of one year after the date of enactment in which to file these claims.

5. Coordination of Certain Amendments Made by the Highway Revenue Act of 1982 and Public Law 97-473 (sec. 722(b) of the Act)

Prior Law

The Highway Revenue Act of 1982 revised Code section 103(m) to clarify that interest on certain obligations is tax exempt under section 103 and that therefore the shareholders of regulated investment companies holding those obligations qualify for tax-free treatment on the distributions of the interest on those obligations. Public Law 97-473 also revised old section 103(m) to provide cross references. Because the Highway Act was signed prior to P.L. 97-473, the question arose whether the provision relating to Code section 103(m) contained in the Highway Act was repealed by the later-signed law.

Explanation of Provision

The Act clarifies that Public Law 97-473 did not repeal the exempt interest provision added by the Highway Revenue Act.

6. Principal Campaign Committees (sec. 722(c) of the Act and sec. 527(h) of the Code)

Prior Law

Under prior law, the principal campaign committee of a candidate for Congress was taxed by using the graduated corporate rates. The principal campaign committee was the committee designated by the candidate.

Explanation of Provision

The Act provides that if the candidate has only one campaign committee, that committee will be treated as the principal campaign committee without the necessity of a designation.

7. Fuel Production Credit (sec. 722(d) of the Act and sec. 44D of the Code)

Prior Law

Prior and present law (sec. 29) provide a credit for the production of fuel from nonconventional sources equal to $3.00 per barrel of oil equivalent (adjusted for inflation) after 1979. This credit phases out as the annual average wellhead price of uncontrolled domestic crude oil, as estimated by the Secretary, increases from $23.50 (adjusted for inflation) to $29.50 (adjusted for inflation). This phase out is accomplished by the setting of a "reference price" for each year. Under prior law, the credit with respect to production of fiscal year taxpayers was determined by taking into account the reference price for the calendar year in which the producers fiscal year began.

Explanation of Provision

Under the Act, the reference price on which the amount of the production credit depends will be the reference price for the calendar year in which the fuel is sold rather than for the calendar year in which the producers fiscal year begins. This amendment ensures that producers of nonconventional fuels sold on the same day will have the same credit regardless of whether they have the same tax accounting year.

8. Percentage Depletion Basis Adjustments (sec. 722(e) of the Act and secs. 705 and 1367 of the Code)

Prior Law

Under prior law, the basis of a partnership interest of stock in an S corporation was generally increased by the excess of depletion deductions in excess of basis. However, the amendments made by the 1975 and 1982 Acts relating to oil and gas depletion failed to follow this rule.

Explanation of Provision

The treatment of the basis of partnership interests and S corporation stock with respect to oil and gas depletion is conformed to the treatment of percentage depletion generally.

9. Clarification of Basis in Case of Certain Transfers to Partnerships (sec. 722(f) of the Act and secs. 722 and 723 of the Code)

Prior Law

The Tax Reform Act of 1976 provided that gain is recognized when property is contributed to a partnership which is an investment company (sec. 721(b)).

Explanation of Provision

The Act clarifies that the basis of the contributed property and the basis of the partnership interest is increased only by the gain recognized under section 721(b).

10. Public Law 98-259 (sec. 722(g) of the Act and sec. 692(c) of the Code)

Prior Law

Public Law 98-259 forgave certain Federal income tax liabilities for U.S. military or civilian employees who die as a result of wounds or injuries sustained overseas either in certain military actions involving U.S. Armed Forces or in a terroristic activity directed against the U.S. or its allies (including a multinational force in which the U.S. participates).

Explanation of Provision

The Act makes the following amendments to Public Law 98-259:

(1) The effective date is changed from individuals wounded after December 31, 1979, to individuals wounded after November 17, 1978.

(2) The determination of whether terroristic action was directed against the U.S. or its allies is to be based on a preponderance of the evidence.

(3) The required relationship between the overseas wound or injury and the individual's death is clarified by providing that the individual must be a U.S. employee both at the date of incurring the wound and at the date of death.

(4) The definition of U.S. employees is modified so that the Director General of the Multinational Force and Observers in the Sinai who died February 15, 1984 is treated as a civilian employee of the United States while serving in that position.

11. Interest and Dividend Tax Compliance Act of 1983 (sec. 722(h) of the Act and secs. 643, 3405, and 3406 of the Code)

Prior Law

(a) Under prior and present law, a broker who is not the payor of an instrument is required to notify the payor when the purchaser of the instrument is subject to backup withholding because either the purchaser failed to certify that he is not subject to backup withholding or the Internal Revenue Service has notified the broker that the purchaser is subject to backup withholding due to notified payee underreporting. These are two of the four conditions under which backup withholding must be imposed; prior law did not require that the broker notify the payor if the purchaser were subject to backup withholding due to one of the other conditions under which backup withholding must be imposed. Prior law required that the broker provide this notice within 15 days after the date of acquisition of the instrument.

(b) Under prior and present law, the Internal Revenue Service can notify a payor of interest, dividends, or patronage dividends, that it must commence backup withholding with respect to a specified payee. The Internal Revenue Service may do so after it has determined that the payee has underreported interest, dividends, or patronage dividends on his tax return. Under prior law, the Internal Revenue Service notified the payor of the requirement to impose backup withholding because of underreporting, "but not the reasons therefor." The purpose of this provision was to prohibit the Internal Revenue Service from disclosing the nature or details of the payee's underreporting. This provision of prior law could also have been read to prohibit the Internal Revenue Service from disclosing the fact that backup withholding was being imposed due to underreporting. Under prior and present law, the Internal Revenue Service can also notify a payor to impose backup withholding because the payee has furnished an incorrect TIN. Thus, there are two distinct conditions under which the Internal Revenue Service can notify a payor to impose backup withholding. If the Service cannot notify the payor of the reason that backup withholding is being imposed, the payor cannot notify the payee, who would be unable to stop backup withholding because he would not know the reason that it was being imposed.

(c) The interest and dividend withholding provisions enacted in TEFRA included an amendment to section 643 providing rules for passing the credit for withheld taxes, where appropriate, from a trust or estate to the beneficiaries. When withholding on interest and dividends was repealed, this provision was also repealed. No similar rules were provided for passing through the credit for taxes withheld under backup withholding.

(d) Under prior law, there was some confusion as to the interrelationship of pension withholding and backup withholding. Under prior and present law, most pension payments are reportable under section 6047, from the first dollar of the payment. These payments are subject to pension withholding unless the payee elects out of withholding. Under prior law, most pension payments exceeding $600 were also subject to reporting under section 6041. Under prior and present law, payments reportable under section 6041 are subject to backup withholding. Backup withholding is not imposed, however, on any amount if withholding is otherwise required on that amount. Thus, pension payments with respect to which the payee had not elected out of pension withholding were not subject to backup withholding. If, however, the payee had elected out of pension withholding, and if the payments were reportable under section 6041, the pension payments were subject to backup withholding. Thus, payors of pensions were subject to several systems of withholding.

Explanation of Provision

(a) The Act requires that the broker notify the payor if any of the four conditions under which backup withholding must be imposed applies to the purchaser, so that the payor can notify the purchaser as to how to stop backup withholding. The broker must also provide this notice to the payor within the period of time specified by the Secretary in regulations, but in no event later than 15 days after the acquisition. This will permit the notice from the broker to the payor to be included in the computer-generated transfer documents that the broker transmits to the payor in connection with the acquisition. These transfer documents are ordinarily sent to the payor within 7 days following the acquisition. Current Treasury regulations require that the notice relating to backup withholding be transmitted to the payor in connection with these transfer documents. It was the intention of Congress that this procedure be continued.

(b) The Act provides that the Internal Revenue Service can notify the payor that backup withholding is imposed because of payee underreporting. The Internal Revenue Service is still prohibited, however, from disclosing the nature or details of the payee's underreporting.

(c) The Act restores to section 643 technical rules relating to the passing through of the credit for withheld taxes from the estate or trust to the beneficiaries.

(d) The Act clarifies that backup withholding does not apply in the pension withholding area. The Act provides that, if the payee of a pension has not provided his TIN to the payor of the pension or if the Internal Revenue Service notifies the payor that the payee has provided an incorrect TIN, an election out of pension withholding is not effective. Additionally, the pension withholding convention that treats a payee as a married individual claiming three exemptions in cases where the payee has filed no withholding allowance certificate is not effective. Consequently, in these circumstances, if the payee has not filed a withholding allowance certificate, the payee is treated as a single individual claiming no withholding allowances (see Treas. Reg. sec. 31.3402(f)(2)-1(a)).

This provision applies to pension payments made after December 31, 1984, unless the payor elects to have the provision apply to payments on or before that date. Thus, if a payor makes a pension payment on January 1, 1985, to a payee who had elected out of pension withholding in 1984 but who did not furnish his TIN, the payor may not treat that election out of pension withholding as effective. The payor must withhold from that payment, and all subsequent payments until the payee furnishes his TIN, as if the payee were single claiming no withholding allowances.

D. Technical Corrections to Highway Revenue Act of 1982

1. Application of Retail Truck and Trailer Excise Tax to Vehicles Including Used Parts (sec. 731 of the Act and sec. 4052 of the Code)

Prior Law

The Highway Revenue Act repealed the prior 10-percent manufacturers excise tax on certain trucks and trailers and imposed the tax as a retail excise tax. The new tax is imposed at a 12-percent rate on the first retail sale of taxable trucks and trailers. Under prior law, the tax treatment of used components installed in a taxable vehicle was unclear.

Explanation of Provision

The Act clarifies that the value of any used component included in a taxable truck or trailer (if furnished by the first user of the taxable vehicle) is excluded in determining the retail price of (and thereby the excise tax on) the truck or trailer.

2. Application of Gasoline Excise Tax to Alcohol Fuels Mixtures (e.g., Gasohol) (sec. 732 of the Act and secs. 4081(c) and 6427 of the Code)

Prior Law

The Highway Revenue Act provided a 5 cent-per-gallon exemption for certain alcohol fuels mixtures (e.g., gasohol) from the excise taxes on gasoline and diesel fuel. Section 912 of the 1984 Act increases this exemption to 6-cents-per-gallon effective on January 1, 1985. Prior law was unclear as to whether the exemption applied to the alcohol fuels mixture or the taxable fuel component thereof.

Explanation of Provision

The Act clarifies that the exemption applies to the alcohol fuels mixture, and not solely to the gasoline or diesel fuel component of the mixture. A conforming amendment is made to the floor stocks tax imposed on certain alcohol fuels mixtures held for sale on April 1, 1983.

3. Certain Chain Operators of Retail Gasoline Stations Treated as Producers (sec. 733 of the Act and sec. 4082(d) of the Code)

Prior Law

The Highway Revenue Act increased the excise tax on gasoline to 9 cents per gallon. The tax is imposed on the sale by a producer or importer. For purposes of this tax, the term "producer" includes wholesale distributors who (1) sell gasoline to producers, to retailers, or to users who purchase the gasoline in bulk quantities for delivery into bulk storage tanks and (2) elect to be so treated. Under prior law, these distributors (jobbers) could purchase gasoline without payment of tax for sale to independent dealers for retail sale, the tax being imposed upon such later sale. Persons who sold gasoline to retail dealers under common management with such persons did not qualify, however, as wholesale distributors.

Explanation of Provision

The Act provides that, for purposes of the gasoline tax, wholesale distributors also include chain operators who (1) purchase gasoline from a producer and distribute the gasoline to 10 or more retail stations under common management with such operator and (2) who elect to be so treated. These distributors will be entitled to purchase gasoline without payment of tax for sale at the commonly managed retail stations, the tax being imposed upon the later sale to the retail station. For purposes of this rule, retail sale of the same brand of gasoline is not sufficient to indicate common management. This amendment is effective for sales after September 30, 1984.

4. Floor Stocks Refunds for Tax-Reduced Tires (sec. 734(a) of the Act and sec. 523(b) of the Highway Revenue Act)

Prior Law

The Highway Revenue Act provided for refund of certain previously paid manufacturers excise taxes on articles on which tax was repealed. No refund was provided for articles on which tax was reduced, but not repealed.

Explanation of Provision

The Act clarifies that floor stocks refunds also are available with respect to tires on which the excise tax was reduced, but not repealed, on January 1, 1984. The refund is limited to the reduction in tax.

5. Collection of Excise Tax on Noncommercial Aviation Gasoline (sec. 734(c) of the Act and new secs. 4082(e) and 6427(j) of the Code)

Prior Law

A tax of 12 cents per gallon is imposed on gasoline used in noncommercial aviation aircraft. Under prior law, the tax consisted of two parts: a 9-cents-per-gallon tax on gasoline collected at the manufacturer's level (sec. 4081) plus a 3-cents-per-gallon tax collected at the retail level (sec. 4041(c).

Explanation of Provision

The Act provides that the 12-cents-per-gallon excise tax on gasoline used in noncommercial aviation aircraft is collected at the retail level, effective on October 1, 1984. The aviation gasoline dealer (under new sec. 4082(e)) is treated as a "producer" of gasoline and thus is able to purchase such gasoline without payment of tax from the gasoline manufacturer or producer. An aviation gasoline dealer includes any person who regularly sells gasoline to owners, lessees, or operators of aircraft for use as fuel in such aircraft in noncommercial aviation. An aviation gasoline dealer must register with the IRS in order to purchase gasoline without payment of tax.

6. Floor Stocks Refunds for Tread Rubber and Retread Tires (sec. 734(d) of the Act, sec. 523(b) of the Highway Revenue Act, and sec. 4072 of the Code)

Prior Law

The Highway Revenue Act repealed, effective on January 1, 1984, the tax of 5 cents per pound on tread rubber used in recapping or retreading highway tires. The Act provided for floor stocks refunds with respect to tread rubber on which the tax was paid previously and which remained in inventory on December 31, 1983, but not for tread rubber that had been placed on tires before that date, which tires remained inventory on that date.

Explanation of Provision

The Act provides that tread rubber which had been placed on retread tires prior to January 1, 1984, qualifies for a floor stocks refund. The Act also clarifies that such refunds are available for retread tires on which tax was reduced, but not repealed, in the same manner as for new tax-reduced tires. Only one such refund per tire may be received.

7. Other Technical and Conforming Changes (secs. 734(b), (c), and (e)-(h) and 735 of the Act, secs. 513(c), 521(c), and 523(b) of the Highway Revenue Act, and secs. 4051, 4053, 4061, 4063, 4071, 4073, 4082, 4216, 4218, 4221, 4227, 4481, 6302, 6412, and 6416 of the Code)

Explanation of Provisions

The Act restates as part of the new truck and trailer retail excise tax the exemptions previously provided under the repealed manufacturers excise tax.

The Act clarifies that refunds of tax paid on articles used as components in the manufacture of later articles generally are to be paid to the person who paid tax on the later article rather than the person who paid tax on the component.

The Act clarifies that the liability of installers for the truck and trailer retail excise tax on certain parts and accessories installed on taxable vehicles within six months of their purchase is secondary to the liability of the truck or trailer owners.

The Act clarifies that administrative provisions of the Code applicable to the highway excise taxes also apply to the floor stocks taxes imposed by the Highway Revenue Act.

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The Act clarifies two provisions relating to the heavy vehicle use tax. First, the Act clarifies that owner-operators eligible for a one-year delay in the increased heavy vehicle use tax rates will be subject to a full year's tax at the prior-law rates during 1984 (rather than a partial year's tax because of the previously scheduled expiration date of September 30, 1984). Second, the Act provides that no inference is to be drawn from the 1982 amendments with respect to the taxation of trailers based on their "customary use" for periods before the effective date of those amendments.

The Act clarifies that the Treasury Department may prescribe depositories other than the Federal Reserve Bank for wire transfer deposits of the gasoline tax.

Finally, the Act repeals provisions of the Code made obsolete by the Highway Revenue Act.

E. Effective Date

Except as otherwise described, the amendments made by the Technical Corrections title took effect as if included in the original legislation to which each amendment relates.

F. Revenue Effect

The provisions contained in the Technical Corrections title will increase new fiscal year budget receipts by less than $5 million in 1984, and by less than $10 million per year in 1985-1989.

TITLE VIII—FOREIGN SALES CORPORATIONS

(Secs. 801-805 of the Act and new secs. 921-27 of the Code)[1]

A. Prior Law

Tax treatment of DISCs generally

Prior law provided for a system of tax deferral for corporations known as Domestic International Sales Corporations, or "DISCs," and their shareholders. Under this system, the profits of a DISC were not taxed to the DISC but were taxed to the shareholders of the DISC when distributed or deemed distributed to them. Each year, a DISC was deemed to have distributed a portion (discussed below) of its income, thereby subjecting that income to current taxation in the shareholders' hands.[2] Federal income tax could generally be deferred on the remaining portion of the DISC's taxable income until the income is actually distributed to the DISC shareholders, a shareholder disposes of the DISC stock, the DISC is liquidated, distributed, exchanged, or sold, the corporation ceases to qualify as a DISC, or the DISC election is terminated or revoked.

Prior to the Tax Reform Act of 1976, a DISC was deemed to have distributed income representing 50 percent of its export profits and 100 percent of its non-export profits. Thus, the tax deferral available under the DISC provisions was limited to 50 percent of the export income of the DISC. The 1976 Act modified DISC so that the deferral was available only for incremental export income. DISC benefits (now a deferral of tax on at most 42.5 percent of profits)[3] were limited to income attributable to export gross receipts in excess of 67 percent of average export gross receipts in a 4-year base period. These provisions are known as the incremental provisions. The base period years are the fourth, fifth, sixth, and seventh preceding years. For example, the base period is 1974 through 1977 for taxable years beginning in 1981. If the taxpayer did not have a DISC in any year which would be included in the base period for the current year, the taxpayer was required to calculate base period export gross receipts by attributing a zero amount of

[1] For legislative background of the provision, see: "Deficit Reduction Act of 1984" as approved by the Senate Committee on Finance on March 21, 1984, secs. 501-505; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 630-661; Senate floor amendment, 130 Cong. Rec. S. 4662 and 4663 (April 12, 1984); H. Rep. No. 98-861 (June 23, 1984), pp. 968-977 (Conference Report); and H. Con. Res. 328, 130 Cong. Rec. S. 8942 (June 29, 1984), H. 7524 (June 29, 1984) The Act also makes amendments to the following Code sections: 245, 246, 274, 275, 291, 441, 901, 904, 934, 936, 951, 956, 992, 993, 996, 999, 1248, 6011, 6072, 6501, 6686, and 7651.

[2] In the typical case, a DISC is a wholly owned subsidiary of a U.S. corporation, so distributions and deemed distributions from DISCs are typically subject to corporate tax and, eventually, to shareholder level tax when distributed to shareholders.

[3] The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) provided for a 15-percent cutback in certain corporate tax preferences. This provision reduced the tax benefit from DISC by 15 percent, which results in a deferral of tax on at most 42.5 percent rather than 50 percent of profits.

export gross receipts to that base period year. A DISC with adjusted taxable income of $100,000 or less was exempt from the incremental rule. This exemption was phased out as adjusted taxable income increased from $100,000 to $150,000.

The incremental provisions included special rules to deal with situations where a corporation had an interest in more than one DISC, or where a DISC and the underlying trade or business giving rise to the DISC income had been separated. The purposes of these rules were, first, to ensure that in every year the base period export gross receipts which were attributable to a DISC for purposes of deemed distributions in the current year were appropriately matched with the current period export receipts of the DISC and, second, to prevent taxpayers from creating multiple DISCs, or swapping DISCs, to avoid the effect of the incremental rule.

To qualify for the deferral, a DISC was required to be incorporated under the laws of any of the States or the District of Columbia, have only one class of stock, have outstanding capital stock with a par or stated value of at least $2,500, elect to be treated as a DISC, and satisfy the gross receipts and gross assets tests.

Under present and prior law, the gross receipts test requires that at least 95 percent of the corporation's gross receipts consist of qualified export receipts. In general, qualified export receipts are receipts, including commission receipts, derived from the sale or lease for use outside the United States of export property, or from the furnishing of services related or subsidiary to the sale or lease of export property. Certain managerial services performed by a DISC for an unrelated DISC are qualified export receipts, provided that at least 50 percent of the gross receipts of the DISC performing the services are qualified export receipts. Interest on any obligation which is a qualified export asset is also an export receipt. Export property must be manufactured, produced, grown, or extracted in the United States. Generally, exports subsidized by the U.S. Government or exports intended for ultimate use in the United States do not qualify as export property. The President has the authority to exclude from export property any property which he determines (by Executive order) to be in short supply. Under the Tax Reduction Act of 1975, energy resources, such as oil and gas and depletable minerals, were ineligible for DISC benefits. That Act also eliminated DISC benefits for products the export of which is prohibited or curtailed under the Export Administration Act of 1969 by reason of scarcity. The Tax Reform Act of 1976 reduced DISC deferral on sales of military goods to half the amount which would otherwise be allowed.

Under present and prior law, the gross assets test requires that at least 95 percent of the corporation's assets qualify as export assets. Qualified export assets include inventories, export property, necessary operational equipment and supplies, trade receivables from export sales (including certain commissions receivable), producers' loans, working capital, obligations of domestic corporations organized solely to finance export sales under guaranty agreements with the Export-Import Bank, and obligations issued, guaranteed, or insured by the Export-Import Bank or the Foreign Credit Insurance Association. In certain situations, nonqualified assets and receipts may be distributed in order to satisfy these qualification requirements.

Under present and prior law, if a DISC failed to meet the qualifications for any reason, the DISC provisions provided for recapture of the DISC benefits received in previous years. Recapture of accumulated DISC income (because the DISC has become disqualified) was required to be spread out over a period equal to two years for each year that the DISC was in existence (up to a maximum of 10 years).

Under present and prior law, the DISC provisions include special elective intercompany pricing rules, which may be used in lieu of the general intercompany pricing rules of the Code, in order to determine the profits which a DISC may earn on products which it purchases from a related company and then resells for export or which it sells on a commission basis. In general, a DISC may earn up to 4 percent of gross export receipts from a transaction or 50 percent of combined taxable income of the DISC and its related party derived from export gross receipts; in either case, the DISC also earns 10 percent of export promotion expenses. Export promotion expenses include freight expenses to the extent of 50 percent of the cost of shipping export property aboard airplanes owned and operated by U.S. persons or ships documented under the laws of the United States in those cases where the law does not require use of such airplanes or ships. (Alternatively, the DISC and its related party may choose a price determined under the usual arm's-length rules.) Neither the 4-percent method nor the 50-50 method can be applied to cause a loss to the related supplier while the DISC is earning a net profit.

Under marginal costing rules, if the 50-50 method is used by the DISC, only the marginal or variable production and sales costs for the export property need be included in the computation of combined taxable income. In general, the benefits of marginal cost pricing are limited to instances where the variable cost margin on the DISC's export sales of a product is less than the full cost margin on the combined product sales by the DISC and the related supplier.

A DISC's taxable year did not have to conform to the taxable year of any of its shareholders. A wholly owned DISC would frequently have a taxable year ending one month after its parent's taxable year ends. This difference in taxable years allowed 11 months of tax deferral on income of a type deemed distributed to the parent.

Source of income from export sales

The United States taxes U.S. taxpayers on their U.S. and foreign source income, but allows a foreign tax credit for foreign taxes on foreign source income. The credit is subject to a limitation: it cannot exceed the U.S. tax on the foreign source income. In general, in calculating the limitation, most foreign source income is grouped together in a general category known as the "all other" category. A separate limitation or "basket" applies to certain income from deemed DISC distributions (another separate limitation applies to certain interest). In most cases, an export sale will not attract foreign tax so long as the U.S. seller does not maintain a fixed place of business or perform substantial activities in the country of destination. The reason for the separate limitation was that Congress, in enacting the original DISC legislation, did not intend to enable taxpayers to reduce U.S. tax on low-taxed or untaxed distributions from DISCs by crediting foreign taxes on non-DISC income against the U.S. tax on distributions from DISCs.

Income of a U.S. person that exports property produced in the United States directly (without using a DISC) is treated as income partly from within and partly from without the United States (sec. 863(b)). This income is not subject to the separate foreign tax credit limitation applicable to DISC income. To the extent that the income is from sources without the United States, it increases the taxpayer's foreign tax credit limitation in the general "all other" category, and thus the foreign taxes that the taxpayer may credit.

An approximation of the portion of income from a typical direct export sale that is foreign source income is 50 percent (see Treas. Reg. sec. 1.863-3(a)(2) (Example (2)). Therefore, a taxpayer with substantial excess foreign tax credits who can make an export sale directly (rather than through a DISC) without incurring foreign tax on the transaction may be subject to tax on only half the income from the export sale.

For example, a U.S. exporter who can make an export sale at a profit of $100 may be able to treat $50 of that income as foreign source. The taxpayer may be able to arrange the sale so that the $50 of foreign source income attracts no foreign tax. Given sufficient excess foreign tax credits, the foreign source income from the sale will attract no U.S. tax, either. In that case, the taxpayer will be taxable on only the $50 of income that is U.S. source income.

By contrast, that exporter with excess foreign tax credits may have been taxable on $59 of income if it routed the export sale through a DISC. The following table assumes a 16-percent deferral rate for combined taxable income (CTI) of DISC and parent.

PRIOR LAW DISC—50/50 SPLIT OF CTI (CODE SEC. 863(b))

[Exporter With Excess Foreign Tax Credits]

Parent		DISC	
U.S. source (taxable)	$25	Deferred	$16
Foreign source (taxable)	25	Deemed distribution	34
	$50		$50
Taxable:			
U.S. source income of parent			$25
Deemed distribution-separate basket			34
			$59
Exempt:			
Foreign source income of parent			$25
Deferred in DISC			16
			$41

Therefore, some exporters with excess foreign tax credits chose not to route their export transactions through DISCs.

B. Reasons for Change

Since its enactment, the DISC had been the subject of an ongoing dispute between the United States and certain other signatories of the General Agreement on Tariffs and Trade (GATT), who contended that the DISC amounted to an illegal export subsidy that violates the GATT. In 1976, a GATT panel determined that the DISC, as well as certain export tax practices of Belgium, France, and the Netherlands, had some characteristics of an illegal export subsidy. In the case of the DISC, the Panel Report pointed to the failure to charge interest on deferred taxes as the offending export subsidy. While the United States has not conceded that the DISC violated the GATT, in December 1981 the United States agreed to the adoption of the GATT Panel Reports on the DISC and the related tax practices of Belgium, France, and the Netherlands subject to a GATT Council decision which was understood to qualify the findings in the panel reports (the "1981 Decision"). (The GATT Council is the ruling body of the GATT.)

The 1981 Decision provided that GATT signatories are not required to tax export income attributable to economic processes located outside their territorial limits. Furthermore, the 1981 Decision stated that arm's-length pricing principles should be observed in transactions between exporting enterprises and foreign buyers under common control. Finally, the 1981 Decision stated that the GATT does not prohibit the adoption of measures to avoid the double taxation of foreign source income.

A debate in the GATT Council ensued in early 1982 on the interpretation of the 1981 Decision as it applied to the DISC. This debate delayed progress on other issues of critical interest to the United States.

The European Community (EC) argued that the DISC was an illegal export subsidy because it allowed indefinite deferral of direct taxes on income from exports earned in the United States. The United States defended the DISC on the grounds that its effect on trade as an incentive for exports approximated the effect of the territorial system of taxation used by our European trading partners and found to be consistent with the GATT in the 1981 Decision. The majority of the GATT Council members urged the United States to bring the DISC clearly into conformity with the GATT. The EC went one step further to request authorization from the GATT Council to take retaliatory action against the United States. The EC alleged that the DISC had provided more than $2 billion in subsidies for U.S. exports to member countries of the EC over the previous 10 years. Also, other countries expressed an interest in receiving compensation for the DISC.

The DISC debate in the GATT Council highlighted the potential danger of a breakdown in the GATT dispute-settlement process, and the isolation of the United States over the DISC issue. To remove the DISC as a contentious issue and to avoid further disputes over retaliation, the United States made a commitment to the GATT Council on October 1, 1982, to propose legislation that would address the concerns of other GATT members. In March 1983, the Administration approved the general outlines of a proposal to replace the DISC with a territorial-type system of taxation for U.S. exports designed to comply with GATT.

Congress did not find the GATT arguments against DISC persuasive and believed the EC had made no credible showing of any injury resulting from DISC exports. Nonetheless, in the interest of resolving the GATT dispute over DISC and assisting the Administration in fulfilling its commitment to the GATT Council, Congress enacted legislation that is consistent with the general outlines of the Administration's proposal. Under GATT rules, a country need not tax income from economic processes occurring outside its territory. Accordingly, Congress believed that certain income attributable to economic activities occurring outside the United States should be exempt from U.S. tax in order to afford U.S. exporters treatment comparable to what exporters customarily obtain under territorial systems of taxation. Congress intended that certain activities and economic processes related to that income would be undertaken by a foreign sales corporation outside the U.S. customs territory. A foreign tax credit is not available with respect to such income; international double taxation is avoided by use of the exemption method. Congress intended that the Act result in approximately the same revenue cost to the U.S. Treasury as the DISC.

Congress recognized that the Act would affect prior law DISCs in different ways, and that some DISCs could have difficulty meeting the foreign presence requirements of foreign sales corporations. Small business exemptions were included to mitigate the effects of the new legislation on such entities. Nonetheless, Congress considered the foreign presence requirements of the legislation to be essential in responding to the GATT rules which formed the background of this legislation.

Although it was aware that the EC had again raised questions about the GATT compatibility of certain aspects of this proposal, Congress enacted this legislation based on its own assessment, and that of the Administration, that the legislation satisfies GATT rules. In light of the considerable effort required to replace the DISC and the new burdens placed on U.S. exporters, Congress expected the Administration to defend vigorously the legislation against any GATT challenge and to inform Congress immediately of all GATT developments relating to the legislation.

C. Explanation of Provisions

1. Overview

The Act provides that a portion of the export income of an eligible foreign sales corporation (FSC) will be exempt from Federal income tax. It also allows a domestic corporation a 100-percent dividends-received deduction for dividends distributed from the FSC out of earnings attributable to certain foreign trade income. Thus, there is no corporate level tax imposed on a portion of the income from exports.

Under the GATT rules, an exemption from tax on export income is permitted only if the economic processes which give rise to the income take place outside the United States. In light of these rules, the Act provides that a FSC must have a foreign presence, it must have economic substance, and that activities that relate to its export income must be performed by the FSC outside the U.S. customs territory. Furthermore, the income of the FSC must be determined according to transfer prices specified in the Act: either actual prices for sales between unrelated, independent parties or, if the sales are between related parties, formula prices which are intended to comply with GATT's requirement of arm's-length prices.

The Act provides that the accumulated tax-deferred income of DISCs operating under prior law will be deemed previously taxed income and, therefore, exempt from taxation.

Congress recognized that small exporters could find it difficult to comply with certain of the foreign presence and economic activity requirements. The Act provides, therefore, two options to alleviate the burden of the foreign presence and economic activity requirements to eligible small businesses: the interest-charge DISC and the small FSC.

In general, where the provisions of the Act are identical or substantially similar to the DISC provisions under present and prior law, Congress intended that rules comparable to the rules in regulations issued under those provisions be applied to the FSC.

2. Foreign sales corporations generally

General requirements

To qualify as a FSC, a foreign corporation must have adequate foreign presence. To have adequate foreign presence, the Act provides that a foreign corporation must satisfy each of the following six requirements.

(1) *Foreign organization.*—The corporation must be created or organized under the laws of a foreign country (which meets certain requirements) or possession of the United States. In other words, the corporation must be formed under the laws of a jurisdiction outside U.S. customs territory. For purposes of this provision, a possession of the United States includes Guam, American Samoa, the Commonwealth of the Northern Mariana Islands, and the Virgin Islands of the United States, but does not include Puerto Rico. If the corporation is organized in a foreign country, that country must be either (a) a party to an exchange of information agreement that meets the standards of the Caribbean Basin legislation (Code sec. 274(h)(6)(A)(i)) ("CBI Agreement"), or (b) an income tax treaty partner of the United States, provided the Secretary of the Treasury certifies that the exchange of information program with that country under the treaty is satisfactory. (On November 6, 1984, a Treasury news release certified 23 countries as having satisfactory treaties.) In addition, the country of organization must be authorized to exchange information with respect to the FSC (whether or not the FSC is a resident of that country). Congress intended that the exchange of information requirement not be limited to FSC information, but apply to all income tax information. Moreover, Congress intended that the Treasury evaluate the practical effectiveness of each treaty information exchange program in the context of actual taxpayer transactions involving the treaty country and the United States.

Congress was aware that exchange of information with certain countries is limited because of restrictions under their domestic law. Congress was also aware that exchange of information programs may be ineffective if corporate stock may be issued in bearer share form. Congress expected that the Secretary of the Treasury would take such factors into account in determining whether to qualify a country under this provision.

A foreign entity classified as a corporation under section 7701(a)(3) (relating to the definition of "corporation") will be considered a corporation for purposes of this requirement.

(2) *Shareholders.*—A FSC may have no more than 25 shareholders at any time during the taxable year. A member of the corporation's board of directors that holds qualifying shares required to be owned by a resident of the country under whose laws the FSC is organized will not count as a shareholder for this purpose.

(3) *Preferred stock.*—A FSC may not have any preferred stock outstanding during the taxable year. Congress intended that a FSC be allowed to create more than one class of common stock for bona fide business purposes. However, one or more of the rights of a class of stock may be disregarded if the right has the effect of avoidance of Federal income tax. For instance, dividend rights may not be used to direct dividends from exempt foreign trade income to shareholders that have taxable income and to direct other dividends to shareholders that have net operating loss carryovers.

(4) *Office and books of account outside the U.S.*.—A FSC must maintain an office located outside the United States, and maintain a set of the permanent books of account at that office. For this purpose, "United States" means the 50 States, the District of Columbia, and the Commonwealth of Puerto Rico. To satisfy this requirement, Congress intended that the office conduct activities comparable to those of a "permanent establishment" under income tax treaty concepts. More than one FSC may share an office. The office need not be located in the country in which the FSC is organized; however, the office must be in a country which is either a party to a CBI agreement with the United States or an income tax treaty partner, which the Treasury certifies as having a satisfactory exchange of information program under the treaty. Congress intended that a foreign country, to qualify for this treatment, not be a country that has a statute (or other stated policy) which denies the IRS access to the home office of the FSC for audit purposes. Therefore, Congress intended that the Treasury assure itself of access to the home office of a FSC before certifying a treaty partner or before entering into an exchange of information agreement.

The permanent books of account must include at least invoices, the quarterly income statements, and a year-end balance sheet of the FSC. In addition, a FSC must maintain at a location in the United States such books and records as are sufficient under Code section 6001 to establish the amount of gross income, deductions, credits or other matters required to be shown in the FSC's tax return.

(5) *Board of directors.*—At all times during the taxable year, the FSC must have a board of directors which includes at least one individual who is not a resident of the United States. However, the

nonresident member of the FSC's board of directors may be a citizen of the United States.

(6) *Controlled group.*—A FSC may not be a member at any time during the taxable year of any controlled group of corporations of which an interest-charge DISC is a member. (After December 31, 1984, the only DISCs will be interest-charge DISCs.)

Small FSC

A FSC may elect to be a small FSC with respect to a taxable year (and succeeding years) provided that it is not a member at any time during the taxable year of a controlled group of corporations which includes a FSC (unless the other FSC has also made a small FSC election).

3. Exempt foreign trade income

Under the Act, a portion of the foreign trade income of a FSC may be exempt from Federal income tax. To achieve this result, the exempt foreign trade income is treated as foreign source income which is not effectively connected with the conduct of a trade or business within the United States. The portion of foreign trade income that is treated as exempt foreign trade income depends on the pricing rule used to determine the amount of foreign trade income earned by the FSC. If the amount of income earned by the FSC is based on arm's-length pricing between unrelated parties, or between related parties under the rules of section 482, then exempt foreign trade income is generally 32 percent (30 percent to the extent the FSC has corporate shareholders) of the foreign trade income the FSC derives from a transaction. For this purpose, foreign trade income will not include any income attributable to patents and other intangibles which do not constitute export property. If the income earned by the FSC is determined under the special administrative pricing rules, then the exempt foreign trade income is generally 16/23 of the foreign trade income the FSC derives from the transaction. The exemption for the combined taxable income method is 16 percent (16/23 x 23 percent) of combined taxable income; the exemption for the gross receipts method is 16/23 of 1.83 percent, or approximately 1.27 percent of gross receipts (not to exceed 32 percent of FSC income). The provision of the Act that decreases the benefits for certain corporate preference items reduces the exemption to the extent the FSC has corporate shareholders by an additional 1/17th, to 15/23 (but not to exceed 30 percent of FSC income, except in the case of the combined taxable income method) of the FSC's foreign trade income.

For example, assume that a corporation owns 50 percent of the shares of a FSC, and an individual owns the remaining 50 percent. Assume further that the foreign trade income of the FSC is $46. Exempt foreign trade income is generally 16/23 of foreign trade income, or $32. However, the exemption is reduced for corporate shareholders; in this example, the exemption is reduced to $15 for the corporate shareholder but remains at $16 for the individual shareholder. Thus, total exempt foreign trade income is $31. In the case of a FSC having corporate and noncorporate shareholders, it is intended that principles similar to the current DISC rules shall apply. (See Treas. Reg. sec. 1.996-3(g).)

Exempt foreign trade income is an exclusion from gross income of the FSC. Any deductions of the FSC properly apportioned and allocated to the foreign trade income derived by the FSC from a transaction will be allocated on a proportionate basis between exempt and nonexempt foreign trade income. Thus, deductions allocable to exempt foreign trade income may not be used to reduce the taxable income of the FSC.

4. Foreign trade income

Foreign trade income is defined as the gross income of a FSC attributable to foreign trading gross receipts. Foreign trade income includes both the profits earned by the FSC itself from exports and commissions earned by the FSC from products or services exported by others.

Foreign trade income other than exempt foreign trade income (nonexempt foreign trade income) generally will be treated as income effectively connected with the conduct of a trade or business conducted through a permanent establishment within the United States. Furthermore, nonexempt foreign trade income generally will be treated as derived from sources within the United States rather than as foreign source income. Thus, nonexempt foreign trade income generally will be taxed currently and treated as U.S. source income for purposes of the foreign tax credit limitation. If, however, a FSC earns nonexempt foreign trade income in a transaction using a pricing method described in section 482 (sec. 923(a)(2) nonexempt income), the source and taxation of such income (including the creditability of a foreign tax with respect to such income) will be determined in a manner like that of prior law. Nonexempt foreign trade income will be either 7/23 or 68 percent of foreign trade income (8/23 or 70 percent of foreign trade income, to the extent that a FSC has corporate shareholders), depending on the pricing method used in arriving at foreign trade income.

A FSC generally will not be allowed a foreign tax credit or a deduction for foreign income, war profits, or excess profits taxes paid or accrued with respect to exempt or nonexempt foreign trade income (other than sec. 923(a)(2) nonexempt income). In addition, it was intended that a shareholder of a FSC generally will not be eligible for a foreign tax credit with respect to a foreign withholding tax imposed on a dividend attributable to foreign trade income.

Two new categories of income will each be subject to separate foreign tax credit limitations (like DISC distributions under prior law). The first category is taxable income attributable to foreign trade income (at the FSC level). Since none of the taxes that a FSC incurs on foreign trade income is creditable (sec. 906(b)(5)), the function of this separate limitation is to prevent any increase in the FSC's foreign source income in the general "all other" category. The second category of income is distributions from a FSC or former FSC out of earnings and profits attributable to foreign trade income (at the level of the shareholder). The only such distributions that are not eligible for the dividends-received deduction in the hands of a corporate shareholder are those attributable to nonexempt foreign trade income determined without reference to an administrative pricing rule. (The only taxes on foreign trade income that are creditable are those on nonexempt foreign trade income determined without reference to an administrative pricing rule (sec. 901(h)). This separate limitation prevents any increase in the shareholder's general "all other" category of foreign source income. (See also "Other definitions and special rules," below.)

5. Foreign trading gross receipts

In general

In general, the term foreign trading gross receipts means the gross receipts of a FSC which are attributable to the export of certain goods and services (similar to the qualified gross receipts of a DISC under present and prior law). Except for certain receipts not included in foreign trading gross receipts, foreign trading gross receipts are the gross receipts of any FSC that are attributable to the following types of transactions.

(1) *The sale of export property.*—This generally means receipts from the sale, exchange, or other disposition by a FSC, or by any principal for whom the FSC acts as a commission agent, of export property, such as inventory produced in the United States which is sold "for direct use, consumption, or disposition outside the United States" (see Treas. Reg. sec. 1.993-1(b)).

(2) *The lease or rental of export property.*—Leases or rentals of export property by a FSC, or by any principal for whom the FSC acts as a commission agent, to unrelated persons using such property outside the United States will produce foreign trading gross receipts (see Treas. Reg. sec. 1.993-1(c)).

(3) *Services related and subsidiary to the sale or lease of export property.*—Gross receipts from the performance of services which are related and subsidiary to the sale or lease of export property, for which the FSC, or a principal for whom the FSC acts as commission agent, receives foreign trading gross receipts also qualify as foreign trading gross receipts (see Treas. Reg. sec. 1.993-1(d)).

(4) *Engineering and architectural services.*—Receipts from engineering or architectural services on foreign construction projects which are either located abroad or proposed for location abroad qualify as foreign trading gross receipts (see Treas. Reg. sec. 1.993-1(h)).

(5) *Export management services.*—Receipts for certain export management services provided for unrelated FSCs (or DISCs) to aid them in deriving export receipts will qualify as foreign trading gross receipts, but only if, as under the DISC rules, the FSC has at least 50 percent of its income from exporting (see Treas. Reg. sec. 1.993-1(i)).

For the FSC to have foreign trading gross receipts, two additional requirements must be met: the foreign management and foreign economic process requirements. (These requirements do not apply to small FSCs, described below.) A FSC will be treated as having foreign trading gross receipts only if the management of the corporation during the taxable year takes place outside the United States, and only if certain economic processes with respect to particular transactions take place outside the United States. (The management test applies to functions of the FSC for the taxable year. In contrast, the economic process test generally applies to every transaction on a transaction-by-transaction basis. Certain groupings of transactions may be allowed, however, as described below.)

Foreign management

The requirement that the FSC be managed outside the United States will be treated as satisfied for a particular taxable year if (1) all meetings of the board of directors of the corporation and all meetings of the shareholders of the corporation are outside the United States; (2) the principal bank account of the corporation is maintained outside the United States at all times during the taxable year; and (3) all dividends, legal and accounting fees, and salaries of officers and members of the board of directors of the corporation paid during the taxable year are disbursed out of bank accounts of the corporation outside the United States.

Foreign economic processes

The foreign economic process requirements relate to the place where all or a portion of certain economic process activities are performed. The first requirement relates to the sales portion of the transaction, and the second requirement relates to the direct costs incurred by the FSC.[4] In all cases where a FSC or its agent must perform certain activities, the FSC may contract with its U.S. parent or with any other party, related or unrelated, to act as its agent.

Sales portion of the transaction

A FSC will not be considered to earn foreign trading gross receipts from a transaction unless the FSC, or a person under contract with the FSC, participates outside the United States in the solicitation (other than advertising), negotiation, or making of the contract relating to the transaction. This requirement will be satisfied if the FSC, or its agent, performs any one of the three activities with respect to a transaction outside the United States.

The sales requirement will be tested on a transaction-by-transaction basis. However, this requirement will be considered to have been met with respect to sales to a single customer during any taxable year if, for example, (1) the export property consists of either fungible products, or products which are substantially similar (e.g., enumerated in a product category of the Standard Industrial Classification Manual and, for manufactured products, a seven-digit level in the Bureau of the Census, Numerical List of Manufactured Products); (2) the products are sold by the FSC (or its agent) under a single contract; (3) the contract has a term of one year or less which specifies the material terms of each such sale; and (4) if the FSC or its agent performs any one of the three activities once with respect to all such sales.

For purposes of this provision, "solicitation" refers to the communication (either by telephone, telegraph, mail, or in person) by the FSC, or its agent, to a specific, targeted, potential customer re-

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[4] The administrative transfer pricing rules may be used to determine the transfer price of property purchased by a FSC from a related supplier (or to determine the FSC's commission by reference to such pricing rules) only if the FSC or its agent performs all of the economic process activities that are performed in connection with the transaction.

garding a transaction. "Negotiation" includes any communication by the FSC, or its agent, to a customer or potential customer of the terms of sale, such as the price, credit, delivery, or other specification. The term "making of a contract" includes the performance by the FSC, or its agent, of any of the elements necessary to complete a sale such as making an offer or accepting the offer. In addition, the written confirmation by the FSC, or its agent, to the customer of an oral agreement which confirms variable contract terms or specifies (directly or by cross-reference) additional contract terms will be considered the "making of a contract." The FSC may act upon standing instructions from its principal. The location of a solicitation, negotiation, or making of the contract is determined by the place where the activity is initiated by the FSC or its agent.

Direct cost tests

A FSC may not earn foreign trading gross receipts from a transaction unless the foreign direct costs incurred by the FSC attributable to the transaction equal or exceed 50 percent of the total direct costs incurred by the FSC with respect to the transaction (or the FSC meets an alternative 85-percent test, described below).

The term "total direct costs" means, with respect to any transaction, the total direct costs incurred by the FSC attributable to the activities relating to the disposition of export property (five categories of activities are considered). The activities are those performed at any location within or without the United States by the FSC or any person acting under contract with the FSC. The term "foreign direct costs" means the portion of the total direct costs incurred by the FSC which are attributable to activities performed outside the United States. Although the activities must be performed outside the United States, either the FSC or any person acting under contract with the FSC may perform the activities.

The requirement that the foreign direct costs incurred by the FSC equal or exceed 50 percent of the total direct costs incurred by the FSC attributable to a transaction may be met by an alternative 85-percent test. Under this alternative test, a corporation will be treated as satisfying the requirement that economic processes take place outside the United States if the foreign direct costs incurred by the FSC attributable to any two of the five activities relating to disposition of the export property equal or exceed 85 percent of the total direct costs of at least two of those five activities.

Only the direct costs paid or accrued by the FSC or its agent will be taken into consideration in meeting the direct cost test. It is not necessary to incur expenses in all categories to use either the 50-percent or the 85-percent tests. If no costs are incurred with respect to the activities in a category, that category will not be taken into account in meeting the requirement. The direct cost tests will be applied on a transaction-by-transaction basis or by alternative groupings based on product lines, recognized industry or trade usage, or other business criteria. A different direct cost test may be used for different transactions or groupings, that is, the 50-percent test can be used in one transaction, while the 85-percent test can be used in another. Furthermore, the Congress intended that, generally, a FSC will be allowed to group transactions differently for the various purposes for which grouping is permitted.

Congress recognized that certain foreign military sales must be made through the U.S. Government, typically to foreign governments. Accordingly, because of negotiation and other activities with the U.S. Government, many of the expenses incurred by the FSC in connection with such sales are incurred within the United States. Congress intended, therefore, that for purposes of the foreign presence and economic process tests such expenses (and the expenses of the U.S. Government in connection with the sale) will not be taken into account.

Categories of activities

The five categories of activities relating to the disposition of export property are as follows:

(1) Advertising and sales promotion

This category includes two distinct activities: "advertising" and "sales promotion." "Advertising" is an appeal, related to a specific product or product line made through any medium and directed at all or a part of the general population of potential export customers. Advertising not related to a specific product or product line, such as the cost of corporate image building, is not included in the definition of advertising. Advertising primarily directed at customers in the United States will not be considered advertising for purposes of this section.

"Sales promotion" is an appeal made in person to a potential export customer for the sale of a specific product or product line made in the context of trade shows or annual customer meetings. The cost of trade shows and annual customer meetings will be included in the total direct cost of sales promotion. However, the cost of trade shows and customer meetings will not include the cost of salaries and commissions of direct sales people, but will include payments to organizers or other persons hired for the event.

For determining foreign direct costs, the location of the advertising activity will be determined by the place where it is aired, displayed, published, or otherwise presented to the potential customer. With respect to broadcast media, such as radio or television, the location will be determined by the place to which the signal is transmitted. In the case of print media, the location will be determined by where the publication is distributed, not where it is printed. The location of trade promotion activity will be determined by where the customer meeting or trade show is held.

(2) Processing customer orders and arranging for delivery

This category includes two separate activities: "processing customer orders" and "arranging for delivery." "Processing customer orders" means notifying the related supplier of the order and of the requirements for delivery of the export property.

"Arranging for delivery" means taking necessary steps to ship the export property to the customer in accordance with the requirements of the order, but does not include packaging, crating, and similar pre-transportation costs. The direct costs of arranging for delivery will not include shipping expenses. They will include the cost of salaries for clerks, telephone, telegraph, and documentation. Delivery can occur within or outside the United States. For example, a FSC will be considered to have arranged for delivery if the FSC or its agent contacted a trucking company and shipping line to provide transportation for a particular shipment from an interior point in the United States to Rotterdam where the buyer assumes title.

In the case of certain property, where the normal industry practice is to make delivery at or near the place of manufacture of such property within the United States, a FSC will be considered to have arranged for delivery if the FSC or its agent notifies the buyer of the time and place of delivery.

(3) Transportation

Transportation is the activity undertaken by the FSC or its agent for shipping the export property during the period it owns such property. If the FSC is acting as a commission agent, this transportation is the activity that is undertaken to ship the export property after the commission relationship begins, even if the relationship begins after the property leaves the U.S. customs territory.

Total direct costs of "transportation" will include expenses incurred by the FSC or its agent for transporting the export property. The FSC or its agent will not be considered to undertake transportation activity if the customer pays the cost of transportation directly.

The amount of total direct costs treated as foreign direct costs will be determined on the basis of the ratio of mileage outside the U.S. customs territory to total transportation mileage. For example, if 50 percent of the mileage associated with a particular shipment is outside the U.S. customs territory, 50 percent of the transportation expenses will be considered foreign direct costs. The cost of arranging for delivery, defined above, is not included in the definition of total direct costs of transportation. With respect to fungible commodities, total direct costs will include only those transportation costs which are incurred after goods have been identified to a contract.

(4) Determination and transmittal of a final invoice or statement of account and the receipt of payment

This category includes two separate activities: the "determination and transmittal" of the final invoice, and the "receipt of payment." "Determination and transmittal" means the assembly of the final invoice or statement of account and the forwarding of the document to the customer. The "final invoice" is the invoice upon which payment is made by the customer. An invoice transmitted after payment is made, as a receipt for payment, would satisfy this definition. The "statement of account" is any summary statement transmitted to a customer giving the status of transactions occurring within an accounting period that does not exceed one taxable year. A single final invoice or statement of account can cover more than one transaction with one customer.

The costs of office supplies, office equipment, clerical salaries, mail, etc., directly attributable to the assembly and transmittal of a final invoice or statement constitute direct costs for this activity. For example, the cost of assembling the final invoice at the FSC's foreign office and mailing it from that office to the customer would meet this definition. This activity does not include the engineering or cost accounting functions involved in the establishment of a price.

"Receipt of payment" means the crediting of the FSC's bank account by the amount of proceeds associated with the transaction. Initial payment may be received in the United States as long as the proceeds are transferred immediately to a bank account of the FSC outside the United States. The total direct costs for this activity include all the expenses incurred by the FSC for maintaining a bank account in which the payment is deposited.

(5) Assumption of credit risk

This category of activity consists of bearing the economic risk of nonpayment with respect to a sale, lease, or contract for the performance of services. A FSC will be considered to bear such risk if it contractually bears such risk and if either a debt becomes uncollectible within the accounting period or an addition is made to the bad debt reserve of the FSC that is allowed as a deduction under present law (sec. 166). If a debt becomes uncollectible within the accounting period or an addition is made to the bad debt reserve of the FSC, the FSC must subtract from its foreign trade income the appropriate percentage of the FSC's (and related supplier's) bad debt expense. The appropriate percent is 32 percent for transactions in which no administrative pricing rule is used. If the FSC uses the combined taxable income pricing method for a transaction, the appropriate percentage is 23 percent. If the FSC uses the gross receipts pricing method for a transaction, the reduction must be an amount determined by multiplying the bad debt expense of the FSC and its related supplier by the ratio of the FSC's taxable income from the transaction (before exclusion of exempt foreign trade income and associated deductions) to the combined taxable income from the transaction. The combined bad debt expense upon which this adjustment is based must be related to foreign trading gross receipts.

Costs of assuming a credit risk may include costs of assuming the risk of loss, for example, the costs of insuring against the risk of loss. In some circumstances, a taxpayer may not have any receivables that become uncollectible or any other costs of assuming credit risk within the taxable year; even though the taxpayer is contractually assuming the risk of loss, there is no actual loss or bad debt expense. In such cases, the FSC will be considered to bear the risk of loss only if it incurs an actual loss (or is allowed to deduct an addition to a bad debt reserve under present law) in at least one year within a three-year period.

If an FSC contractually assumes the risk of loss but incurs no bad debt expenses in the first two years of operations as a FSC, it cannot satisfy the assumption of credit risk activity in the third year unless it actually incurs a loss in that year. However, even if the FSC does not incur a loss in the third year, it would still be treated as having satisfied the assumption of credit test in the first two years. If the FSC then incurs a loss in the fourth year, it could use the credit test in the fourth, fifth, and sixth years. When the FSC actually incurs a bad debt expense will be determined under present-law rules.

Burden of proof

Under the Senate amendment, the burden of proof would have been shifted to the IRS on certain issues upon a taxpayer affidavit. The Act does not include the Senate provision shifting the burden of proof to the IRS in connection with enforcement of the foreign presence requirements. Congress understood the rationale for this provision—avoiding uncertain application of the detailed and technical foreign presence rules in order to reduce administrative burdens on both the IRS and taxpayers. Nevertheless, Congress believed that the Senate provision created an undesirable precedent. Congress, however, intended the IRS to administer the foreign presence provisions of FSC in a manner which will facilitate the establishment of FSCs and carry out the objectives of the statute.

Excluded receipts

Certain receipts are not included in the definition of foreign trading gross receipts. The first category of excluded receipts are receipts excluded on the basis of use, subsidized receipts, and certain receipts from related parties. Examples of such receipts include the receipts of a FSC from a transaction (1) if the export property or services are for ultimate use in the United States, or are for use by the United States and the use by the United States is required by law or regulation; (2) if the transaction is accomplished by a subsidy granted by the United States; or (3) if the receipts are from another FSC which is a member of the same controlled group. Gross receipts from sales between related FSCs will be excluded from the definition of foreign trading gross receipts; however, sales between unrelated FSCs may qualify. Congress intended that excluded receipts be the same as excluded receipts under the DISC rules, with the following two exceptions.

Under the Act, income from sales of military property and services related to such sales is allowed one-half of the benefits otherwise allowable. This rule is comparable with the DISC rule for a deemed distribution of one-half of the DISC income attributable to military property. "Military property" means any property which is an arm, ammunition or implement of war designated in the munitions list published pursuant to section 38 of the International Security Assistance and Arms Export Control Act of 1976.

Investment income and carrying charges are excluded from the definition of foreign trading gross receipts. Investment income includes dividends, interest, royalties, rents other than from the lease of export property for use outside the United States, gains from the sale or exchange of stocks or securities, and certain other passive income (see "Other definitions and special rules," below). Carrying charges include any amount in excess of the price for an immediate cash sale and any other unstated interest.

Income attributable to excluded receipts will not be foreign trade income and, therefore, no portion of such income will be exempt. Furthermore, a corporate shareholder will not get a dividends-received deduction for distributions attributable to such income. For example, investment income and carrying charges will be included in the taxable income of the FSC and, therefore, subject to full U.S. tax. Distributions to a corporate shareholder from earnings and profits attributable to the investment income and carrying charges will be fully taxed again (to the corporate shareholder) because there will be no dividends-received deduction. In other words, the investment income and carrying charges will be subject to tax at the FSC level, the corporate shareholder level and, like all other dividends from the corporate shareholder to its shareholders, also at the shareholder level. At the FSC level, investment income will be eligible for foreign tax credits.

6. Transfer pricing rules

Congress intended that the pricing principles that govern the determination of the taxable income of a FSC comply with the GATT rules. If export property is sold to a FSC by a related person (or a commission is paid by a related principal to a FSC with respect to export property), the taxable income of the FSC and related person is based upon a transfer price determined under an arm's-length pricing approach or under one of two formulae which are intended to approximate arm's-length pricing.

Conditions on use of administrative transfer pricing rules

In order to use the special administrative pricing rules, a FSC must perform significant economic functions with respect to the sales transaction. Accordingly, a FSC must meet two requirements. The first requirement is that all of the five activities ("economic process activities") with respect to which the direct costs are taken into account for the 50 percent foreign direct costs test must be performed by the FSC or by another person acting under contract with the FSC. These five activities are advertising and sales promotion, processing of customer orders and arranging for delivery of the property, transportation, billing and receipt of payment, and the assumption of credit risk. The second requirement for use of the administrative pricing rules is that all of the activities relating to the solicitation (other than advertising), negotiation, and making of the contract for the sale must be performed by the FSC (or by another person acting under contract with the FSC). These two requirements can be met wherever the activities are performed—the activities do not have to be performed outside the United States. It is only necessary that the activities be performed by the FSC or by another person acting under contract with the FSC.

Example.—The interaction of this condition for the use of the administrative pricing rule and the foreign economic process requirements may be illustrated as follows: P, a domestic corporation, owns all of the stock of S, a corporation organized under the laws of a foreign country that qualifies as a FSC for the taxable year. P manufactures product A, which it sells to S for resale to export customers. During S's taxable year, S sells 10 units of A to F, a foreign customer. The terms of sale are FOB P's plant in Seattle. P, acting as agent for S, performed all of the solicitation and negotiation activities with respect to the transaction with F. S accepted F's offer of purchase at its office in the foreign country. S incurred expenses of $90 for the cost of advertising, $85 of which was attributable to print advertising in the Asian editions of trade magazines. S also incurred $10 of direct costs for trade shows in the United States promoting sales of A to domestic and foreign customers, and $25 of direct costs (incurred outside the United States) in processing P's order. No costs are associated with arranging for the delivery of the transportation of the product because of the terms of sale. S incurred all of the credit costs associated with the transaction. S compensated P on an arm's-length basis for its services.

S will be allowed to use one of the two administrative pricing rules to determine its transfer price from P for the units of A sold in the transaction, because S or an agent of S performed all of the economic process activities with respect to the transaction. S will also satisfy the foreign economic process requirements with respect to the transaction because (1) S participated in making the contract outside of the United States, and (2) 85 percent of S's direct costs for two of the five categories of activities subject to the direct cost tests (advertising and sales promotion and processing of customer orders and arranging for delivery) were attributable to activities occurring outside the United States. (S's direct costs include payments to P for services rendered.)

To summarize, to be treated as having foreign gross receipts and hence foreign trade income, the foreign costs of certain activities relating to the disposition of export property must be substantial (either 50 percent of the cost of all five activities or 85 percent of the cost of two of the activities). To use the administrative pricing rules, all five of the activities must be performed by the FSC or by another person acting under contract with the FSC. Furthermore, other activities (solicitation, negotiation, and making of the contract of sale) must be performed by the FSC or by another person acting under contract with the FSC.

Determination of transfer price

For purposes of applying the administrative pricing rules, combined taxable income is determined without regard to the exclusion of exempt foreign trade income. Taxable income may be based upon a transfer price that allows the FSC to derive taxable income attributable to the sale in an amount which does not exceed the greatest of (1) 1.83 percent of the foreign trading gross receipts derived from the sale of the property; (2) 23 percent of the combined taxable income of the FSC and the related person (these two pricing rules are termed the administrative pricing rules); or (3) taxable income based upon the actual sales price, but subject to the rules provided in section 482.

Example.—An example of the calculations to determine a transfer price using the section 482 method and the alternative administrative pricing method is as follows: A FSC purchases export property from a related supplier and sells the property for $1,000 of foreign trading gross receipts. The FSC incurs expenses attributable to the sale of $225. The related supplier's cost of goods sold attributable to the export property is $550. The related supplier's expense incurred in connection with the sale of the export property is $125. For purposes of this example, it is assumed that the related supplier has no other deductible expenses. It is also assumed that if the related supplier sold the export property to the FSC for $720, the price could be justified as satisfying the standards of section 482, which would allow the FSC to earn $55 on the sale. Under the facts assumed, the FSC may earn, under the more favorable of the two administrative pricing rules, a profit of $23 on the sale.

The FSC's taxable income and the transfer price to the FSC from the transaction, using the administrative pricing methods, and the FSC's taxable income if the transfer price is determined under section 482, would be as follows:

(*a*) *Combined taxable income:*

FSC's foreign trading gross receipts	$1,000.00
Cost of goods sold of related supplier	(550.00)
Combined gross income	$450.00
Less expenses:	
Direct expenses of related supplier	$125.00
Direct expenses of FSC	225.00
Total expenses	(350.00)
Combined taxable income	100.00

(*b*) *FSC's taxable income and trsnsfer price under combined taxable income method:*

FSC taxable income—23% of combined taxable income in (a) above ($100.00)	23.00
Transfer price to FSC:	
Sales price	1,000.00
Less:	
FSC expenses	(225.00)
FSC profit ($100.00 x 23%)	(23.00)
Total	(248.00)
Transfer price	752.00

(*c*) *FSC's taxable income and transfer price under gross receipts method:*

FSC taxable income—lesser of 1.83% of foreign trading gross receipts ($18.30) or two times amount in (b) above ($46.00)	18.30
Transfer price to FSC:	
Sales price	1,000.00
Less:	
FSC expenses	(225.00)
FSC profit	(18.30)
Total	(243.30)
Transfer price	756.70

(*d*) *FSC's taxable income under section 482*:

FSC profit:	
Sales price	1,000.00
Less:	
FSC cost of goods sold (transfer price)	720.00
FSC expenses	225.00
Total	(945.00)
FSC profit (taxable income)	$55.00

Other transfer pricing matters

The same intercompany allocation to the FSC will be permitted whether the FSC takes title as principal or acts as a commission agent. Congress intended that the administrative pricing rules should be applied under rules which will prevent pricing at a loss to the related supplier. In this regard, Congress believed that the Secretary of the Treasury should consider whether the present regulations accomplish this purpose. Congress also intended that regulations allow the grouping of transactions and marginal costing. Under the administrative pricing rules, the transfer price from the related supplier to the FSC may be computed after the FSC sells the goods to a customer. Furthermore, the FSC and its related supplier may make adjustments upwards or downwards following the close of the taxable year in which the FSC sells the goods.

The transfer pricing rules only apply to determine the price of a sale to a FSC (or FSC commissions). A FSC, or a principal for which the FSC is acting as commission agent, must sell to a related purchaser on an arm's-length basis, under the provisions of section 482 of the Internal Revenue Code, viewing the FSC and any related supplier as a single entity which sells to the purchaser.

While Congress believed that it is appropriate to provide special FSC pricing rules for purposes of administrative convenience, it did not intend for such rules to be applied by the Internal Revenue Service or claimed by taxpayers in transactions not involving a FSC. Congress believed that the Internal Revenue Service should continue its efforts to improve the administration of the section 482 transfer pricing rules.

Taxation of the FSC

As described above, a FSC will not be subject to U.S. tax on exempt foreign trade income. The following example illustrates the determination of exempt foreign trade income using the three transfer pricing methods.

Example.—A FSC sells export property for $1,000 of foreign trading gross receipts. The FSC purchases the property from a related supplier. The FSC's cost of goods sold, based on the transfer prices derived in the previous example, would be $752 under the combined taxable income method, $756.70 under the gross receipts method, and $720 under section 482. The FSC incurs expenses attributable to the sale of $225.

The FSC's foreign trade income, exempt foreign trade income, and expenses properly apportioned and allocated to foreign trade income from the transaction, using the three transfer prices derived in the previous example, would be as follows (without regard to the 1/17 reduction in the FSC benefit that may be imposed by Code sec. 291(a)(4)):

(*a*) *If the transfer price to the FSC was determined under the combined taxable income method:*

Foreign trading gross receipts	$1,000.00
Cost of goods sold	(752.00)
Foreign trade income	248.00
Exempt foreign trade income ((16/23) x $248)	172.52
Expenses allocable to exempt foreign trade income (($172.52/248) x $225)	(156.52)
Taxable income of FSC not subject to U.S. tax ($172.52–$156.52)	16.00

(*b*) *If the transfer price to the FSC was determined under the gross receipts method:*

Foreign trading gross receipts	1,000.00
Less cost of goods sold	(756.70)
Foreign trade income	243.30
Exempt foreign trade income (16/23 x $243.30)	169.04
Expenses allocable to exempt foreign trade income (($169.04/$243.30) x $225)	(156.33)
Taxable income of FSC not subject to U.S. tax ($169.04–$156.33)	12.71

(*c*) *If the transfer price to the FSC was determined under section 482:*

Foreign trading gross receipts	1,000.00
Less cost of goods sold	(720.00)
Foreign trade income	280.00
Exempt foreign trade income (32% x $280)	89.60
Expenses allocable to exempt foreign trade income (($89.60/280) x $225)	(72.00)
Taxable income of FSC not subject to U.S. tax ($89.60–$72.00)	17.60

A FSC's nonexempt foreign trade income will be subject to U.S. tax unless it is determined without reference to an administrative pricing rule, in which case it will be taxed in the same manner and to the same extent as income earned by a foreign corporation that is not a FSC. Interest, dividends, royalties, other investment income and carrying charges will be subject to U.S. tax.

A FSC will not be allowed an investment tax credit or certain other credits. A foreign tax credit will not be allowed to a FSC with respect to foreign taxes on foreign trade income (sec. 906(b)(5)), but will be allowed with respect to other foreign taxes. Foreign trade income (including nonexempt foreign trade income determined without reference to the administrative pricing rules) will be taken into account under a separate limitation for purposes of determining the foreign tax credit limitation of a FSC.

If a foreign corporation elects to be taxed as a FSC, it must waive any rights it could otherwise claim under a U.S. income tax treaty. Except as described above, a FSC will generally be subject to U.S. tax in the same manner and to the same extent as a foreign corporation that is not a FSC.

7. Distributions to shareholders

A FSC will not be required or deemed to make distributions to its shareholders. Actual distributions to shareholders must be made first out of foreign trade income; the FSC may have income that is not foreign trade income, for example, investment income. Distributions will be treated as being made first out of earnings and profits attributable to foreign trade income, and then out of any other earnings and profits. Any distribution made by a FSC which is made out of earnings and profits attributable to foreign trade income to a shareholder which is a foreign corporation or a nonresident alien individual will be treated as a distribution which is effectively connected with the conduct of the trade or business conducted through a permanent establishment of the shareholder within the United States, and as U.S. source income. Thus, such distributions will be subject to Federal income tax.

Foreign trade income and investment income of a FSC will not be subject to the rules of subpart F. In addition, the Secretary of the Treasury is authorized to exclude property related to the export activities of the FSC from the subpart F rules relating to investments by controlled foreign corporations in U.S. property. However, Congress clarified (in connection with the factoring provision added to the Code by sec. 123 of the Act) that income of a controlled foreign corporation from loans to finance the purchase of its related party's goods is subpart F income subject to the separate foreign tax credit limitation for interest.

8. Dividends received from a FSC

A domestic corporation will generally be allowed a 100 percent dividends-received deduction for amounts distributed from a FSC out of earnings and profits attributable to foreign trade income. Thus, there will be no corporate level tax on exempt foreign trade income and only a single-level corporate tax (at the FSC level) on foreign trade income other than exempt foreign trade income. However, a 100 percent dividends-received deduction will not be allowed for nonexempt foreign trade income determined without reference to an administrative pricing rule (sec. 923(a)(2) nonexempt income) or a dividend received by a cooperative with respect to foreign trade income that is treated as exempt foreign trade income.

Foreign taxes on FSC dividends attributable to foreign trade income (other than nonexempt foreign trade income determined without reference to an administrative pricing rule) will be treated as noncreditable foreign taxes. In addition, such dividend income will be taken into account for purposes of the foreign tax credit limitation under a separate limitation.

To the extent a corporate shareholder of a FSC distributes dividends attributable to foreign trade income to its individual shareholders, the amounts will be taxed. Likewise, distributions to a noncorporate shareholder of a FSC that are not attributable to foreign trade income will be subject to tax in the same manner as distributions from a foreign corporation that has not elected to be treated as a FSC.

A dividends-received deduction will not be allowed, however, for distributions attributable to other earnings and profits. These distributions will therefore be taxed currently to the shareholders, corporate or noncorporate, of the FSC.

9. Other definitions and special rules

Export property

In general, the term export property means property manufactured, produced, grown or extracted in the United States by a person other than a FSC, held primarily for sale, lease, or rental in the ordinary course of trade or business for direct use or consumption outside the United States, and not more than 50 percent of the fair market value of which is attributable to articles imported into the United States.

Congress intended that the destination test (whether "use, consumption, or disposition occurs outside the United States") will be considered satisfied if the FSC delivers the property to a carrier or freight forwarder for ultimate delivery, use, or consumption outside of the United States. This rule will apply without regard to (1) the F.O.B. point or place of passage of title, (2) whether the purchaser is a United States or foreign purchaser, or (3) whether the property is for use of the purchaser or for resale.

For purposes of this provision, the fair market value of any article imported into the United States will be its appraised value as determined by the Secretary under section 402 of the Tariff Act of 1930 (19 U.S.C. 1401a) in connection with its importation. Congress intended that the Secretary of the Treasury may prescribe regulations for the determination of foreign content of any product, without necessarily following current regulations. In considering this issue, Congress expected the Secretary will take into account the effect of any change on revenue, location of employment, and neutrality between similarly situated taxpayers.

The term export property does not include (1) property leased or rented by a FSC for use by any member of a controlled group of which the FSC is a member, (2) patents and other intangibles, (3) oil or gas (or any primary product) thereof, or (4) products the export of which is prohibited. Export property also excludes property designated by the President as being in short supply. Coal and uranium products, and other depletable products (other than oil and gas), specifically excluded from the definition of export property under the DISC rules are not excluded under the Act.

Cooperatives

Agricultural products marketed through cooperatives are subject to special rules. First, the Act provides that for purposes of computing the foreign trade income of the FSC under the combined taxable income method, the combined taxable income of the cooperative and the FSC will be computed without taking into account patronage dividends and per-unit retain allocations, and certain deductions for nonpatronage distributions under Code section 1382.

Thus, the cooperative will not be required to distribute the income attributable to exempt foreign trade income (generally 16/23 of foreign trade income) to benefit from the exemption from corporate level tax on this income. This special rule will only apply to the cooperative shareholder of the FSC and not to members or patrons of the cooperative that may be cooperatives themselves (higher tier cooperatives).

The second rule provides that the foreign trade income (other than exempt foreign trade income) will be treated as exempt income to the FSC, but only if such income is distributed currently to the cooperative shareholder. If such income is not distributed currently, it will be taxed in the current year at the FSC level. Distributions from the FSC to the cooperative shareholder that are attributable to foreign trade income treated as exempt foreign trade income will be includible in the taxable income of the cooperative (i.e., income eligible for distribution as a patronage dividend as defined in section 1388(a)(3)). Thus, the nonexempt foreign trade income (generally 7/23 of foreign trade income) will not be taxed at the FSC level, but instead will be generally taxed at the member or patron level. In other words, the nonexempt foreign trade income will be subject to a single level of tax (as is provided for cooperatives under subchapter T) as if the cooperative had exported directly rather than through a FSC. Distributions attributable to foreign trade income will be considered attributable first to nonexempt foreign trade income (even if such income is treated as exempt income).

The final rule provides that the cooperative shareholder of a FSC will not be allowed a dividends-received deduction for distributions from the FSC that are attributable to nonexempt foreign trade income. The Act provides this rule because, although the nonexempt foreign trade income is treated at the FSC level as exempt in this case, Congress intended that this portion of the income be includible in the income of the members and patrons without the deferral accorded to exempt foreign trade income. Like other corporations, the cooperative will be allowed a dividends-received deduction for distributions attributable to exempt foreign trade income but not for distributions attributable to passive income.

The special rules for agricultural commodities marketed through cooperatives will be available only if the income of the cooperative eligible for FSC benefits is based on arm's-length transactions between the cooperative and its members or patrons. Congress intended that this rule should prevent the cooperative and its members or patrons from getting additional FSC benefits from transfer prices that do not reflect the fair market value of the property sold to or through the cooperative by its members or patrons.

Gross receipts

In general, the term gross receipts means the total receipts from the sale, lease, or rental of property held primarily for sale, lease, or rental in the ordinary course of a trade or business, and gross income from all other sources.

In the case of commissions on the sale, lease, or rental of property, the amount taken into account for purposes of these provisions as gross receipts will be the gross receipts on the sale, lease, or rental of the property on which the commissions arose.

Investment income

For purposes of the FSC provisions, the term investment income means dividends, interest, royalties, annuities, rents (other than rents from the lease or rental of export property for use by the lessee outside the United States), gains from the sale or exchange of stock or securities, gains from futures transactions in any commodity, amounts includible in computing the taxable income of the corporation under the estate and trust rules, and gains from the sale or disposition of any interest in an estate or trust.

Grouping of transactions

Many of the tests required under the foreign economic processes requirement will be applied on a transaction-by-transaction basis. However, Congress intended that regulations could provide that transactions may be grouped for purposes of the foreign economic process requirements based upon product lines, recognized industry or trade usage, or other business criteria. The regulations could permit different groupings for different purposes. Such flexibility may be important when grouping transactions for purposes of the direct-cost test, for example.

Controlled group of corporations

A controlled group of corporations is defined as in Code section 1563(a) except that a "more than 50" percent ownership test is substituted for the "at least 80 percent" test of that section, and section 1563(b) does not apply.

Other affiliated entities

Under the Act, Webb-Pomerene export organizations may be shareholders of a FSC. Members of a Webb-Pomerene organization will be allowed to sell products through a FSC to the Webb-Pomerene organization and, thus, benefit from the FSC provisions as well as the special provisions under the 1918 Webb-Pomerene Export Trade Act.

Foreign tax credit limitation of related parties

The Act provides a special rule governing the source of income earned by a person related (within the meaning of sec. 482) to a FSC from transactions giving rise to foreign trading gross receipts of the FSC. That related person's foreign source income from such a transaction may not exceed the amount which would be treated as foreign source income earned by that person if the analogous DISC pricing rule applied. For this purpose, the DISC gross receipts pricing rule of Code section 994(a)(1) is analogous to the Act's gross receipts pricing rule in section 925(a)(1); the DISC combined taxable income pricing rule of Code section 994(a)(2) is analogous to the Act's combined taxable income pricing rule in section 925(a)(2); and the DISC section 482 pricing rule of Code section 994(a)(3) is analogous to the Act's section 482 pricing rule in section 925(a)(3).

Congress intended that this special rule governing the source of income, and thus the foreign tax credit limitation of parties related to a FSC, result in foreign source income that is comparable to the foreign source income on a comparable transaction using a DISC under prior law.

This special rule governing the source of income and thus the foreign tax credit limitation of parties related to a FSC is necessary to prevent revenue loss. The table below illustrates the application of the Act (absent this special rule) to a FSC's parent with excess foreign tax credits that exports by selling to its FSC. The table assumes that the parent is a corporation and that 50 percent of the parent's income from the export sale is foreign source income (as might be the case under Code sec. 863(b) absent the Act's special rule). It assumes that the parent has sufficient excess foreign tax credits to offset U.S. tax on all the foreign source income from the export sale. It also assumes that the export sale is subject to the Act's combined taxable income (CTI) rule (section 925(a)(2)). Since this example assumes that the parent is a corporation, exempt foreign trade income is 15/23 (rather than 16/23) of foreign trade income as a result of the special rules relating to corporate preference items (section 291(a)(4)).

FSC–77/23 SPLIT OF CTI ABSENT RESOURCING RULE

[Exporter With Excess Foreign Tax Credits]

Parent		FSC	
U.S. source (taxable)	$38.50	Exempt	$15.00
Foreign source (exempt)	38.50	Taxable	8.00
Total	77.00		23.00

Taxable:	
U.S. source income of parent	38.50
Taxable income of FSC	8.00
Total	46.50
Exempt:	
Foreign source income of parent	38.50
Exempt in FSC	15.00
Total	53.50

Under the DISC rules, the parent's share of combined taxable income is $50 (as illustrated in the table in the Prior Law section). The parent's foreign source income might be $25 under prior law. Exemption of $53.50 under the Act (absent the special rule) would exceed the combination of exemption and deferral of $41 for a parent of a DISC with excess credits under prior law (with a 16 percent deferral rate).[5] To maintain parity with DISC with respect

[5] In the Prior Law section of this document, the taxpayer with excess credits was taxable on $59—$25 of U.S. source income plus a $34 deemed DISC distribution—but paid no tax on $25 of foreign source income or on $16 deferred in the DISC.

to the sourcing rules, the Act would reduce the foreign source income of the parent in the example above from $38.50 to $25, which would result in an exemption of $40. While the reduction in the foreign source income of the parent results in sourcing that is comparable to prior law, the actual exemption is less—$40 rather than $41. The difference ($1) is due to the corporate preference cutback in the exemption rate from 16/23 to 15/23 of foreign trade income. The parent's U.S. source income would increase, under the special rule of the Act, from $38.50 to $52. The following table illustrates the effect of the Act's resourcing rule.

FSC–77/23 SPLIT OF CTI WITH RESOURCING RULE

[Exporter With Excess Foreign Tax Credits]

Parent		FSC	
U.S. source (taxable)	$52.00	Exempt	$15.00
Foreign source (exempt)	25.00	ECI	8.00
Total	77.00		23.00
Taxable:			
U.S. source income of parent			52.00
ECI of FSC			8.00
Total			60.00
Exempt:			
Foreign source income of parent			25.00
Exempt in FSC			15.00
Total			40.00

Participation in international boycotts

The exempt foreign trade income of a FSC will be limited if the FSC participates in or cooperates with international boycotts (as defined in Code sec. 999(b)(3)) and to the extent that any illegal bribe, kickback, or other payment is made to an official employee or agent of a government. Regulations may provide rules similar to those that apply to the deemed distributions of a DISC under section 995(b)(1)(F).

Other rules

The Act provides that no tax may be imposed by any possession of the United States on foreign trade income that arises before January 1, 1987. Congress did not intend that this moratorium on possessions' taxation of foreign trade income be interpreted to exempt income derived by a FSC from sales of export property in the possessions from local taxation. The Act also includes a provision that will require FSCs established in the U.S. Virgin Islands to pay all tax on non-exempt foreign trade income to the United States.

In addition, to the extent provided in regulations, property that is otherwise U.S. property which is held by a FSC and which is related to the export activities of the FSC, will not be treated as an investment in U.S. property (under sec. 956).

Election

A corporation may elect to be treated as a FSC, or a small FSC, for a taxable year at any time during the 90-day period immediately preceding the beginning of the taxable year. Congress intended that a newly formed corporation will be permitted to make an election on or before the 90th day after the beginning of its first taxable year. The Act provides that the Secretary of the Treasury has authority to consent to the making of an election at other designated times. The election must be made in a manner prescribed by the Secretary. The election will be valid only if all shareholders as of the first day of the first taxable year for which the election is effective consent in writing to the election. Once an election is made, it will, unless revoked by the corporation, continue in effect for subsequent years in which the corporation qualifies to be a FSC, unless the corporation fails for five consecutive years to qualify as a FSC (e.g., because of a failure to maintain a foreign office or to have a director that is not resident in the United States).

An election to be treated as a FSC may be revoked by the corporation any time after the first taxable year it is in effect. To be effective for a given taxable year, however, the revocation must be made on or before the 90th day of that year. A revocation made after the expiration of the 90-day period will not be effective until the following taxable year. A properly made revocation relating to a taxable year of the FSC is effective beginning the first day of that year. If the corporation fails to qualify as a FSC for a period of five consecutive taxable years, the FSC election will terminate automatically. A corporation whose FSC election has been terminated may again elect to be a FSC.

In view of the rule that a FSC cannot be a member of a controlled group of corporations of which a DISC is a member, the Act provides that, under regulations to be prescribed by the Secretary, a FSC election will automatically terminate an inconsistent DISC election.

10. Small businesses

In order to provide relief for small businesses that may find the foreign presence and economic activity burdensome, the Act provides two alternatives to the FSC: the interest charge DISC and the small FSC. Congress expressed concern that without a special effort by the Administration many small businesses which wish to export property may avoid making an election to become a FSC or a small DISC because they fear that such an election will lead to undue complexity and a large administrative burden. Consequently, Congress hoped that small businesses will be given special encouragement and assistance by the Commerce Department in establishing and operating small FSCs and interest-charge DISCs.

Interest charge DISC

A DISC may continue to defer income attributable to $10 million or less of qualified export receipts. Deemed distributions relating to base period exports (the incremental rule) and to one-half of the DISC's income will be eliminated. However, 1/17 of the excess of the DISC's income over certain deemed distributions (such as the deemed distribution of 50 percent of the income attributable to military property) is deemed distributed. This cutback in DISC deferral is comparable with the corporate preference cutback of the exempt income of a FSC under Code section 291. Thus, except for the 1/17th cutback, substantially all of the DISC's income attributable to $10 million or less of qualified export receipts may be deferred. However, unlike the prior-law DISC, an interest charge will be imposed on the shareholders of the DISC. The amount of the interest will be based on the tax otherwise due on the deferred income computed as if the income were distributed. The interest rate will be tied to the T-bill rate.

The tax that would otherwise be due on the deferred income, termed the shareholder's DISC-related deferred tax liability, means, with respect to the year of the shareholder, the excess of the tax liability for the year computed as if the deferred DISC income were included in income over the actual tax liability for the year. This amount will be computed without regard to carrybacks to such taxable year. The Secretary of the Treasury is directed to prescribe regulations to provide any adjustments necessary or appropriate in the case of net operating losses, credits, and carryovers.

Deferred DISC income generally means the excess of accumulated DISC income at the beginning of the taxable year over the amount by which actual distributions out of accumulated DISC income exceed the current year's DISC income (termed distributions-in-excess-of-income). For shareholders of the DISC whose taxable year is different from that of the DISC, deferred DISC income is measured from the computation year; with respect to any taxable year of the shareholder, the computation year is the taxable year of the DISC which ends within the shareholder's preceding taxable year. The rate of interest imposed on the shareholder's DISC-related deferred tax liability is determined by reference to a base period T-bill rate; this would mean the annual rate of interest that is equivalent to the average investment yield of U.S. T-bills with maturities of 52 weeks which were auctioned during the one-year period ending on September 30 of the calendar year ending with the close of the taxable year of the shareholder. The Secretary of the Treasury will be expected to publish this rate in October of each year. The interest a taxpayer is required to pay under this provision would be due at the same time the shareholder's regular tax is required to be paid.

Taxable income of the DISC attributable to qualified export receipts that exceed $10 million will be deemed distributed. Thus, if export receipts exceed $10 million, the DISC would not be disqualified; there would merely be no deferral of income attributable to the excess receipts. DISCs which are members of the same controlled group would be treated as a single corporation for purposes of the $10 million rule.

Small FSC

A FSC that elects to be a small FSC need not meet the foreign management and foreign economic process requirements in order to have foreign trading gross receipts. However, in determining the exempt foreign trade income of a small FSC, any foreign trading gross receipts that exceed $5 million will not be taken into account. No exception to the requirements for use of the administrative pricing rules is provided for small FSCs. Because these requirements may be met by the FSC or by another person acting under a contract with the FSC and the activities need not be performed outside the United States, Congress expected that this may not be so onerous a requirement to small exporters as the foreign management and economic process requirements might be.

Small FSCs which are members of the same controlled group will be treated as a single corporation. Regulations will prescribe how the $5 million gross receipts limitation will be allocated among members of a controlled group.

If the foreign trading gross receipts of a small FSC exceed the $5 million limitation, the corporation may select the gross receipts to which the limitation is allocated. This provision will allow a taxpayer to choose, for example, to allocate the limitation to gross receipts attributable to transactions where the profit margin is high; in this case, the amount of exempt income would be greater than if the limitation were allocated to low-margin transactions.

11. Taxable year of DISC and FSC

The taxable year of any DISC or FSC will be required to conform to the taxable year of the majority shareholder (or other group of shareholders with the same taxable year) as determined by voting power. Also, the Act requires any DISC established after March 21, 1984 to conform its taxable year to that of its majority shareholder. Voting power will be determined on the basis of the total combined voting power of all classes of stock of the corporation entitled to vote. Special rules are provided where more than one shareholder or shareholder groups have the highest percentage of voting power. In cases where there are subsequent changes of ownership, the Secretary is directed to prescribe regulations under which these rules will apply only if there is a substantial change of ownership.

12. Transition rules

The taxable year of any DISC which begins before January 1, 1985 and which would otherwise include January 1, 1985, will close on December 31, 1984. To the extent that any underpayment of estimated tax is created or increased by this provision, no penalty will be imposed. The qualified assets test (under sec. 992(a)(1)(B)) will not apply to any taxable year ending on December 31, 1984. That test applies at year-end only. The Act's bunching of DISC year terminations at the end of 1984, absent relief, would have required all DISCs to meet the assets test on December 31, 1984. If Congress had not created this exception, the pool of qualified assets (such as Eximbank debt) might have been too small on that date to prevent undue disqualifications.

Accumulated DISC income

Accumulated DISC income which is derived before January 1, 1985, will be exempt from tax. This result is achieved by treating such income as previously taxed income. However, the Act insures that the provision forgiving the tax on accumulated DISC income will not allow forgiveness of tax on accumulated DISC income that was subject to tax because of a revocation or disqualification prior to requalification and prior to the earning of income that is eligible for forgiveness. Furthermore, Congress intended that tax on distributions to meet qualifications (Code sec. 992(c)) would not be forgiven.

Export Trade Corporations

Export Trade Corporations (ETCs) may elect to discontinue operating as ETCs or elect to be FSCs. If an ETC so elects before January 1, 1985, the previously untaxed income attributable to earnings derived before January 1, 1985, will be treated as previously taxed income. This provision applies to second-tier ETCs in the same manner as first-tier ETCs. Thus, if an ETC elects to convert to a FSC, it can distribute its tax deferred export trade income through its shareholder to the U.S. parent company rather than transferring it to the new FSC, without incurring any U.S. income tax.

ETCs that do not elect to discontinue operating under the ETC rules may continue to operate as ETCs. However, in this case no portion of the untaxed income of the ETC will be treated as previously taxed income under the provisions of this Act.

Distributions

To alleviate the hardship that may result from deemed distributions to a shareholder of a DISC that would otherwise be recognized in income in a later year by the shareholder, a special rule provides for a spread of such income over ten years. Deemed distributions from a DISC attributable to income derived by the DISC in the taxable year of the DISC which begins in 1984 after the date in 1984 on which the taxable year of the shareholder begins will be treated as received by the shareholder in ten equal installments; the installments will be treated as received on the last day of each of the ten taxable years of the shareholder which begins after the shareholder's first taxable year beginning in 1984. Congress expected that regulations will allow taxpayers to accelerate this inclusion if taxpayers elect to do so.

For example, a DISC's taxable year ends January 31 and the corporate shareholder of the DISC is a calendar year taxpayer. In 1984, the corporate shareholder will include in income the deemed distributions from the DISC for the DISC's year ending on January 31, 1984 and, under the Act (absent the ten-year spread), the deemed distributions for the 11-month taxable year ending on December 31, 1984. Almost two years of deemed distributions would be includible in income in 1984. Under the Act, the deemed distributions for the 11-month period ending December 31, 1984, will be spread over a ten-year period and includible in the income of the shareholder in 10 equal installments: on December 31 of 1985 through 1994.

Long-term contracts

The Act provides a transitional rule for taxpayers using the completed contract method of accounting. The transitional rule will apply if a taxpayer (1) has, on March 15, 1984, and at all times thereafter a firm plan, evidenced in writing, to enter into a contract, and (2) enters into a binding contract by December 31, 1984. The transitional rule provides that the taxpayer will be treated as having satisfied the foreign presence tests for periods before and the economic process tests with respect to costs incurred before December 31, 1984, with respect to such transactions. The income from the long-term contract will be treated as FSC income when recognized, provided the general FSC requirements are satisfied after December 31, 1984.

The Act also provides a transition rule for taxpayers with long-term contracts who do not use the completed contract method of accounting. The transitional rule will apply if a taxpayer enters into a binding contract before March 15, 1984. The rule provides with respect to such transactions that the taxpayer will be treated as having satisfied the foreign presence tests for periods before and the economic process tests with respect to costs incurred before December 31, 1984. This rule will apply only to income attributable to such contracts that is recognized before December 31, 1986.

Finally, a transition rule is provided for transactions undertaken pursuant to contracts entered into by a taxpayer on or before December 31, 1984, that are performed, or with respect to which all consideration is includible in income, before the end of the first taxable year of the FSC ending after January 1, 1985. Under this rule, a taxpayer will be treated as having satisfied the foreign presence tests for periods before and the economic process tests with respect to costs incurred before December 31, 1984, with respect to such transactions. (The Act allows regulatory authority to extend rules allowing waiver of foreign presence requirements in the case of certain contracts entered into before January 1, 1985.)

13. Transfers from DISC to FSC

Except to the extent provided in regulations to be prescribed, section 367 (which taxes some transfers of appreciated assets to foreign corporations) will not apply to transfers made generally before January 1, 1986 to a FSC of qualified export assets held on August 4, 1983, by a DISC in a transaction to which section 351 or 368(a)(1) apply.

14. Treasury study

Congress directed the Treasury Department to prepare a study on services. Neither the present DISC provisions nor the FSC benefits allowed under the the Act give special tax benefits for the export of services performed in the United States. Congress believed that this policy should be reviewed so that an informed decision can be made regarding the appropriate treatment of income from the export of services in the future. In particular, Congress expects the study to consider the revenue impact of FSC benefits for services. Congress directed the Secretary of the Treasury, in consultation with the office of the U.S. Trade Representative, to undertake a study of the advisability of providing the benefits allowed under the FSC election for profits from services performed in the United States and sold outside the United States. The Treasury Department is to report on the results of this study to the Senate Committee on Finance and the House Committee Ways and Means no later than six months after enactment.

15. FSC reports

The Act deletes the prior law requirement for DISC reports after 1984 and substitutes a requirement for FSC reports.

D. Effective Date

These provisions generally apply to transactions after December 31, 1984, in taxable years ending after that date.

E. Revenue Effect

These provisions are estimated to decrease fiscal year budget receipts by $62 million in 1985 and 1986, to increase fiscal year budget receipts by $19 million in 1987 and $80 million in 1988, and to decrease budget receipts by $131 million in 1989.

TITLE IX—HIGHWAY REVENUE PROVISIONS

A. Heavy Vehicle Use Tax (secs. 901-903 and 931-934 of the Act, secs. 4481 and 4483 of the Code, and sec. 513 of the Highway Revenue Act of 1982) and Diesel Fuel Tax (secs. 911 and 915 of the Act and secs. 4041, 6427, and 9503 of the Code)[1]

Prior Law

Use tax

An annual excise tax is imposed on the use on the public highways of a highway motor vehicle whose taxable gross weight exceeds a prescribed minimum weight (sec. 4481). Taxable gross weight is determined under regulations prescribed by the Treasury, which may include formulas or other methods for determining the taxable gross weight of vehicles by classes, specifications or otherwise. The tax is paid by the person in whose name the vehicle is registered, and the taxable period begins on July 1. Amounts equivalent to highway use tax receipts are appropriated to the Highway Trust Fund. The tax expires on October 1, 1988.

Tax rate.—For uses occurring before July 1, 1984, the tax rate is $3 per 1,000 pounds of taxable gross weight or fraction thereof. Vehicles of 26,000 pounds or less are exempt.

As enacted in the Highway Revenue Act of 1982, the use tax rate was scheduled to change to a graduated structure on July 1, 1984. The taxable gross weight at which vehicles become subject to the use tax was to have risen to 33,000 pounds. For a vehicle between 33,000 and 55,000 pounds, the tax rate was to have been $50 per year, plus $25 for each 1,000 pounds or fraction thereof over 33,000 pounds. For a vehicle of 55,000 pounds or more, the tax rate was to have been $600 per year, plus $40 (rising to $52 by 1988) for each 1,000 pounds or fraction thereof over 55,000 pounds. The maximum tax rate, applicable to vehicles over 79,000 pounds, was to have been $1,600 per year (rising to $1,900 by 1988).

Prior law did not provide a reduced tax rate for the highway use of a vehicle solely because it is registered as a logging vehicle.

Operating rules.—Two rules are generally effective as of July 1, 1984. First, a credit or refund is allowed pro rata, if a vehicle on which use tax has been paid is retired from service because of theft, accident or other casualty. Second, a vehicle that travels fewer than 5,000 miles on the public highways during a taxable

[1] For legislative background of the provisions, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, secs. 1201-1203; H. Rep. No 98-432, Pt. 2 (March 5, 1984), pp. 1815-1820; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, secs. 601-603 and 611; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 662-666; Senate floor amendments, 130 Cong. Rec. S4319 (April 11, 1984), 130 Cong. Rec. S4516 (April 12, 1984), and 130 Cong. Rec. S4538 (April 12, 1984); and H. Rep. No. 98-861 (June 23, 1984), pp. 1228-1232 (Conference Report).

period is exempt, regardless of taxable gross weight (sec. 4483). Prior law did not provide a special de minimis mileage exemption for a vehicle solely because it is an agricultural vehicle.

Small owner-operators.—Special rules were to have applied in the case of a person (a small owner-operator) who owns and operates no more than 5 taxable vehicles during a taxable period (sec. 513(f)(2) of the Highway Revenue Act of 1982). Beginning July 1, 1984, the tax rate applicable to small owner-operators in any taxable period was to have been the tax rate generally applicable to persons other than small owner-operators in the immediately preceding taxable period. In addition, the 5,000-mile exemption and proration for theft or accident were not to have been effective for small owner-operators until July 1, 1985.

Diesel fuel tax

An excise tax of 9 cents a gallon was imposed on the sale of diesel fuel for use in a highway vehicle (sec. 4041(a)(1)). The tax expires on October 1, 1988.

A number of complete exemptions are provided, including an exemption for diesel fuel sold to a State or local government or nonprofit educational organization for its exclusive use (sec. 4041(g)). Also, a refund or credit was allowed for the entire amount of tax paid for diesel fuel used in an intercity, local or school bus (sec. 6427(b)).

Amounts equivalent to diesel fuel tax receipts are appropriated to the Highway Trust Fund. One-ninth of these amounts was designated for the Mass Transit Account in the Highway Trust Fund (sec. 9503(e)(2)). At the prior law rate of tax, this generally resulted in designating one cent per gallon of the diesel fuel tax to the Mass Transit Account.

Reasons for Change

Congress believed that the highway excise taxes needed to be restructured to reduce the effect of the heavy vehicle use tax. Congress concluded that the higher rates scheduled to take effect under the Highway Revenue Act of 1982 would have imposed a large tax on trucking operations which did not necessarily relate to the amount of business they might do, and that an alternative form of highway excise taxation should be devised which is more definitely correlated with the use of trucks. Therefore, Congress decided to substitute a higher diesel fuel tax for a lower use tax.

However, Congress did not believe that the heavy vehicle use tax should be eliminated. One objective of highway excise taxation is to impose taxes on highway users that are proportionate to the public highway costs which are allocable to their respective uses. These costs generally depend not only on mileage but also on vehicle weight. Taxes that correlate only with mileage are insufficient for satisfying the objective of cost allocation. Thus, Congress decided to retain so much of a heavy vehicle use tax that varies with vehicle weight as is necessary (when taken in combination with increases in the diesel fuel tax) to approximately maintain the prior law relation between highway taxes and allocable costs for various types of highway vehicles.

Finally, Congress believed that the combined effects of modifications to the highway excise taxes should not result in any significant change in Highway Trust Fund receipts over the scheduled duration of those taxes.

Explanation of Provisions

1. Heavy vehicle use tax

The Act restructures and reduces the highway use tax rate generally, revises the operating rules for small owner-operators, provides special rules for certain logging and agricultural vehicles, and requires that studies be conducted of the use tax.

Tax rate.—Vehicles with a taxable gross weight under 55,000 pounds are exempt from the highway use tax. For a vehicle of 55,000 pounds or more, the tax rate is $100 per year, plus $22 for each 1,000 pounds or fraction thereof over 55,000 pounds. The maximum tax rate, applicable to vehicles over 75,000 pounds, is $550 per year.

Small owner-operators.—For the taxable period beginning on July 1, 1984 only, the tax rate for small owner-operators is $3 per 1,000 pounds for vehicles of 55,000 pounds or more. However, if this special rule would produce a greater use tax on a small owner-operator's vehicle than does the general use tax rate described above, then the general rate applies to that vehicle. Moreover, the 5,000-mile exemption and proration for theft or accident are made available to small owner-operators beginning July 1, 1984, one year earlier than under prior law and the same date as these operating rules are effective for other taxpayers.

Logging vehicles and agricultural vehicles.—The amount of use tax is reduced by 25 percent for a vehicle that is (1) used exclusively to haul harvested forested products to and from the forested site and (2) registered (under the laws of the State in which the vehicle is required to be registered) as used in the transportation of harvested forested products.

The 5,000-mile exemption is increased to 7,500 miles for a vehicle that is (1) used primarily for farming purposes and (2) registered (under the laws of the State in which the vehicle is required to be registered) as used for farming purposes. The term "farming purposes" means direct use in agricultural production or transportation of farm commodities to or from a farm.

Study requirements.—The Act directs the Secretary of Transportation, in consultation with the Secretary of the Treasury, to conduct studies of the highway use tax and to submit reports to the tax-writing committees of Congress not later than October 1, 1987. The studies relate to (1) whether vehicles of 80,000 pounds or more bear their fair share of the costs of the highway system, (2) the significance of the use tax for trans-border trucking operations, and (3) the feasibility of weight-distance truck taxes.

2. Diesel fuel tax and credit

Increase in diesel fuel tax

The Act increases the excise tax on highway diesel fuel to 15 cents a gallon. The Act does not affect prior exemptions from the entire amount of the tax, including exemptions for diesel fuel sold to a State or local government or nonprofit educational organization for its exclusive use. However, the credit or refund of tax paid on diesel fuel used in a privately operated intercity, local or school bus (which was allowed for the entire amount of tax under prior law) is generally increased to 12 cents a gallon, resulting in an effective tax of 3 cents a gallon. This credit or refund is 15 cents a gallon (hence, no effective tax applies) in the case of diesel fuel used in a local bus while furnishing transportation available to the general public and along regularly scheduled routes, provided that the bus has a seating capacity of at least 20 adults (not including the driver) and is operated under contract with a State or local government or such government pays more than a nominal subsidy toward the operation of the bus. It is anticipated that a technical correction will extend the 15-cents-a-gallon refund or credit to contractors who provide school bus service that is a direct substitute for self-operated service, the fuel for which would be exempt from this tax if purchased by a State government, local government or nonprofit school.[2]

Diesel fuel tax credit

To offset the increase in fuel costs for light vehicles, the Act provides a one-time rebate equal to the estimated extra diesel fuel tax to be paid over the expected remaining life of a qualified vehicle. In general, a qualified vehicle is a diesel-powered car, truck or van which has a gross vehicle weight rating of 10,000 pounds or less and is registered for highway use in the United States under the laws of any State. The rebate is available to the first person (the "original purchaser") who buys a new qualified vehicle for use other than resale, if the purchase occurs after January 1, 1985, and before 1988. No rebate is allowed for used vehicles purchased during this period. The amount of the rebate is $102 for a car and $198 for a truck or van. It is claimed once, generally as a credit on the income tax return of the original purchaser for the taxable year in which the purchase is made. There is no recapture of the rebate if the person who properly claimed the rebate for a qualified vehicle should later sell the vehicle.

The rebate is also available to the person who on January 1, 1985, holds a qualified vehicle for use other than resale. It is claimed once, generally as a credit on the income tax return of the holder of the vehicle in the taxable year which includes December 31, 1984. Because the remaining life of an older vehicle is generally less than that of a new vehicle, the amount of the rebate in this case depends on the model year of the vehicle, as follows:

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[2] See, letter of October 2, 1984, from Chairman Rostenkowski, Committee on Ways and Means, and Chairman Dole, Committee on Finance, to the Secretary of the Treasury, Donald T. Regan.

If the model year is—	The rebate is—	
	Car	Truck or van
1984 or 1985	$102	$198
1983	85	165
1982	68	132
1981	51	99
1980	34	66
1979	17	33

No rebate is available if the model year is 1978 or earlier.

To ensure that the rebate operates only to compensate the vehicle purchaser for increased payments of diesel fuel tax, the Act provides that the basis of a qualified vehicle for which the rebate is allowed is reduced by the amount of the rebate. In addition, no rebate is allowed to a State or local government or a nonprofit educational organization, as these entities are exempt from the diesel fuel tax.

Designation of diesel fuel tax for Mass Transit Account

To maintain the same effective designation of amounts to the Mass Transit Account, the Act provides that one cent per gallon (rather than one-ninth) of the diesel fuel tax is designated for that account.

Effective Date

The provisions relating to the highway use tax generally are effective beginning on July 1, 1984, except that the study requirements are effective upon enactment.

The provisions relating to the highway diesel fuel tax are effective beginning on August 1, 1984.

Revenue Effect

The highway use tax and diesel fuel tax provisions are estimated to reduce net fiscal year budget receipts by $152 million in 1984 and $51 million in 1985, and to increase net fiscal year budget receipts by $84 million in 1986, $37 million in 1987, $183 million in 1988, and $52 million in 1989.

B. One-year Extension of Refund of Taxes on Fuels Used in Qualified Taxicabs (secs. 914 and 935 of the Act and sec. 6427 of the Code) [3]

Prior Law

Excise taxes are imposed on the sale of gasoline, diesel fuel, and special motor fuels used in highway motor vehicles. The rate of tax in the case of gasoline and special motor fuels is 9 cents per gallon. Diesel fuel was subject to a 9-cents-per-gallon tax under prior law. (As of August 1, 1984, that rate increased to 15 cents per gallon.)

A partial exemption from the motor fuels taxes is provided for fuel used in certain taxicabs (Code sec. 6427(e)). The amount of the exemption is 4 cents per gallon. Exemption is accomplished by a refund (without interest) paid by the Treasury Department to the ultimate purchaser of the fuel. To qualify for this refund, a taxicab must be operated by a licensed person who is not prohibited by company policy or local law from furnishing shared transportation and the taxicab generally must not be of a type that has below-average fuel economy. This partial exemption was scheduled to expire on October 1, 1984.

Reasons for Change

Congress believed that additional time was needed to assess the effectiveness of the exemption for fuels used by qualified taxicabs in promoting energy savings through shared transportation and to determine whether any adjustment of the exemption is needed. Accordingly, a limited extension of the exemption for fuels used in qualified taxicabs was included in the Act.

Explanation of Provisions

The Act extends for one year the 4-cents-per-gallon exemption for fuels used in certain taxicabs. Thus, the exemption will expire on October 1, 1985.

The Act also directs the Secretary of the Treasury to conduct a study of the effectiveness of this exemption, and to report with recommendations thereon to Congress, before January 2, 1985.

Effective Date

The extension of the partial tax-exemption for fuels used in qualified taxicabs became effective on the date of enactment (July 18, 1984).

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[3] For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 612; S. Prt. 98-169, Vol. I (April 2, 1984), p. 667; and H. Rep. No. 98-861 (June 23, 1984), p. 1232 (Conference Report).

Revenue Effect

The provision is estimated to reduce net fiscal year budget receipts by $2 million in 1985, and by a negligible amount in 1986.

C. Increase in Excise Tax Exemption for Alcohol Fuels Mixtures and Alcohol Fuels; Alcohol Fuels Credit; and Duty on Imported Alcohol Fuels (secs. 912 and 913 of the Act and secs. 44E (redesignated sec. 40 by the Act), 4041, 4081, and 6427 of the Code, and Item 901.50 of the Tariff Schedules of the United States (19 U.S.C. 1202))[4]

Prior Law

Excise tax exemptions for alcohol fuels mixtures and alcohol fuels

Alcohol fuels mixtures

Prior law provided a 5-cents-per-gallon exemption from the excise taxes on gasoline, diesel fuel, and special motor fuels for fuels consisting of mixtures of any of those fuels with at least 10 percent alcohol (Code secs. 4041, 4081, and 6427). The term alcohol is defined to include only alcohol derived from a source other than petroleum, natural gas, or coal.

Alcohol fuels

Prior law provided a 9-cents-per-gallon exemption from the excise tax on special motor fuels for certain "neat" methanol and ethanol fuels (sec. 4041). "Neat" alcohol fuels are fuels comprised of at least 85 percent methanol, ethanol, or other alcohol. The exemption did not apply to alcohol fuels derived from petroleum or natural gas.

Alcohol fuels credit

An income tax credit is allowed for alcohol used in certain mixtures of alcohol and gasoline (e.g., gasohol), diesel fuel, or any special motor fuel if the mixture is sold by the producer for use as a fuel or is so used by the producer (sec. 44E, redesignated sec. 40 by the Act). The credit also is permitted for alcohol (e.g., qualified methanol fuel) other than alcohol mixed with gasoline, diesel fuel, or special motor fuel, that is used by the taxpayer in a trade or business or is sold at retail by the taxpayer and placed in the fuel tank of the purchaser's vehicle. The credit is available only if the sale or use is in a trade or business of the person claiming the credit. Under prior law, the credit was equal to 50 cents for each gallon of alcohol used as a fuel.

The amount of any person's allowable alcohol fuels credit is reduced to take into account any benefit received with respect to the

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[4]For the legislative background of the provisions see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, secs. 613-614; S. Prt. 98-169, Vol. I (April 2, 1984), p. 668; Senate floor amendment, 130 Cong. Rec. S4538 (April 12, 1984); and H. Rep. No. 98-861 (June 23, 1984), p. 1233 (Conference Report).

alcohol under the excise tax exemptions for alcohol fuels mixtures or alcohol fuels.

For purposes of the credit, the term alcohol includes methanol and ethanol, but does not include alcohol produced from petroleum, natural gas, or coal, or alcohol with a proof less than 150.

Duty on imported alcohol fuels

Prior law imposed a duty equal to 50 cents per gallon on alcohol imported into the United States for use as a fuel (19 U.S.C. 1202).

Reasons for Change

Congress believed that tax incentives for alternative fuels are required at a higher level because recent declines in gasoline prices have made it more difficult to develop a viable alcohol fuels industry in the United States. Congress believed that providing an increased incentive for development of such an industry was consistent with the national policy of promoting energy self-sufficiency through encouragement of alternative fuels.

Explanation of Provisions

Excise tax exemptions for alcohol fuels mixtures and alcohol fuels

Alcohol fuels mixtures

The Act increases the excise tax exemption for alcohol fuels mixtures (e.g., gasohol) to 6 cents per gallon. An additional amendment is made to clarify that alcohol derived from peat is to be treated as derived from coal in determining availability of this exemption for alcohol fuels mixtures.

Alcohol fuels

The Act retains the prior-law 9-cents-per-gallon exemption for qualified alcohol fuels derived from a substance other than petroleum or natural gas and provides a new 4-1/2-cents-per-gallon exemption for such fuels derived from natural gas. Alcohol fuels that are derived from petroleum continue to be subject to the full 9-cents-per-gallon excise tax on special motor fuels.

Alcohol fuels credit

The Act increases the alcohol fuels credit to 60 cents per gallon. The Act further clarifies that alcohol produced from peat is deemed to be produced from coal; therefore, such alcohol is not eligible for the credit when used in an alcohol fuels mixture or as an alcohol fuel.

Duty on imported alcohol fuels

The Act increases to 60 cents per gallon the duty on alcohol imported into the United States for use as a fuel.

Effective Date

These provisions are effective on January 1, 1985.

Revenue Effect

These provisions are estimated to decrease net fiscal year budget receipts by $44 million in 1985, $65 million in 1986, $69 million in 1987, $74 million in 1988, and $73 million in 1989.

D. Temporary Reduction in Excise Tax on Piggyback Trailers (secs. 921 and 936 of the Act and sec. 4051 of the Code) [5]

Prior Law

A 12-percent excise tax is imposed on the first retail sale of truck trailer and semitrailer chassis and bodies which are suitable for use with a trailer or semitrailer which has a gross vehicle weight over 26,000 pounds (sec. 4051). Amounts equivalent to the receipts from this tax are appropriated to the Highway Trust Fund. The tax expires on October 1, 1988.

Exemptions are provided for certain articles, including rail trailers and semitrailers designed for use both as a highway vehicle and a railroad car. Piggyback trailers, which are designed to ride only on highways but are equipped to be lifted onto and transported by rail cars, are not exempt as rail trailers. Prior law did not provide a reduced rate of tax for an article solely because it is a piggyback trailer or semitrailer.

Reasons for Change

Congress was concerned that the full application of the sales tax on highway trailers to piggyback trailers might be inconsistent with the exemption allowed for rail trailers, since much of the movement of piggyback trailers, like that of rail trailers, is via rail. On the other hand, Congress was concerned that an exemption for piggyback trailers might be inconsistent with the treatment of other highway trailers which are fully subject to the sales tax regardless of the amount of highway usage. Therefore, Congress decided to reduce temporarily the sales tax as it applies to piggyback trailers, pending further study of the appropriate treatment of these trailers.

Explanation of Provision

The Act provides that the 12-percent excise tax on the sale of heavy trailers is temporarily reduced to 6 percent in the case of piggyback trailers and semitrailers. This reduced tax rate applies only to sales made during the one-year period beginning on the day of enactment of the Act, at the end of which period the tax rate returns to 12 percent.

A trailer qualifies for the reduced tax rate if three conditions are met. First, the purchaser must certify to the seller, according to regulations prescribed by the Secretary, that the trailer will be used (or resold for use) principally in connection with trailer-on-

[5] For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 621; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 671-672; H. Con. Res. 328, 130 Cong. Rec. S8948 (June 29, 1984), H7529 (June 29, 1984); and H. Rep. No. 98-861 (June 23, 1984), pp. 1234-1235 (Conference Report).

flatcar rail service. Second, the trailer must be designed for that use. Third, both the purchaser and seller must be registered with the Secretary. However, if the subsequent use or resale of the trailer fails to meet these conditions—for example, the trailer is put to a use which is not principally in connection with trailer-on-flatcar rail service—then the first such user or reseller is liable for payment of an additional excise tax. This additional tax is equal to the 6-percent excise tax that was not collected on the first retail sale by virtue of the special excise tax rate for piggyback trailers.

The Act requires the Secretary of Transportation to report to the tax-writing committees of Congress before May 2, 1985, on the appropriate application and level of the excise tax to piggyback trailers.

Effective Date

The provision applies to piggyback trailers and semitrailers the first retail sale of which occurs after July 17, 1984, and before July 18, 1985.

Revenue Effect

The provision is estimated to reduce net budget receipts by $5 million in fiscal year 1985.

TITLE X—MISCELLANEOUS REVENUE PROVISIONS

A. Tax Treatment of Capital Gains and Losses

1. Decrease in Holding Period Required for Long-Term Capital Gain Treatment (sec. 1001 of the Act and sec. 1222 of the Code)[1]

Prior Law

For noncorporate taxpayers, only 40 percent of net long-term capital gains are included in taxable income, while 100 percent of net short-term gains are included. In addition, net capital losses are deductible against $3,000 of ordinary income to the extent of 100 percent of short-term losses and 50 percent of long-term losses.

For corporate taxpayers, net long-term capital gains are subject to an alternative tax rate of 28 percent, while net short-term gains are taxed at ordinary corporate rates. Capital losses of corporations are not deductible against ordinary income.

Under prior law, gains or losses on sales or exchanges of capital assets held for more than 12 months were considered long-term capital gains or losses.

Reasons for Change

The differential tax treatment of short-term and long-term transactions creates incentives for investors not to realize short-term gains. Studies of capital asset sales data confirm that investors are "locked-in" to investments because they do not desire to realize short-term gains. This reduces capital market efficiency because investors hold assets longer than they otherwise might in the absence of tax considerations. Prior to 1977, the holding period was 6 months. By reducing the capital gains holding period from 12 to 6 months, the Congress believed that the lock-in effect and its adverse impact on capital market efficiency will be reduced.

Explanation of Provision

The holding period for determining whether gain or loss on the sale or exchange of a capital asset or certain business property is long-term or short-term is reduced from 1 year to 6 months. Thus, property held for more than 6 months will be eligible for long-term capital gain or loss treatment.

The Act makes numerous conforming changes to reflect the reduced 6-month holding period.[2]

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[1] For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 858; S. Prt. 98-169, Vol. I (April 2, 1984), p. 819; and H. Rep. No. 98-861 (June 23, 1984), p. 1263 (Conference Report).

[2] The holding period for incentive stock options (sec. 422A) was not changed by the Act. The one-year holding period adopted by Congress in 1981 for incentive stock options, in contrast to

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Effective Date

The provision applies to assets acquired after June 22, 1984, and before January 1, 1988.

Revenue Effect

This provision is estimated to decrease fiscal year receipts by less than $10 million in 1984 and 1985, $279 million in 1986, $268 million in 1987, $286 million in 1988, and $280 million in 1989.

the three-year holding period for qualified stock options under prior law, was chosen because Congress believed that such a period was an appropriate length of time to allow the conversion of what would otherwise be ordinary income into long-term capital gains. Also the one-year period relating to depreciation recapture under section 1250(b)(1) was retained. That period was established in 1964 when the capital gains holding period was 6 months.

2. Repeal of Special Rule for Pre-1970 Capital Loss Carryovers (sec. 1002 of the Act and sec. 1212 of the Code)[3]

Prior Law

Capital losses of individuals are deductible in full against capital gains. In addition, $3,000 of capital losses are deductible against ordinary income. Any amount of unused capital losses may be carried forward to future years indefinitely.

For losses from years after 1969, only 50 percent of net long-term capital losses in excess of net short-term capital gains may be deducted from ordinary income. Thus, $6,000 of net long-term capital losses is required to offset $3,000 of ordinary income. However, under prior law, for losses from years before 1970, 100 percent of the net long-term capital losses in excess of net short-term gains could be deducted from ordinary income.

Reasons for Change

In the interests of tax simplification, the Congress decided that it is now appropriate to repeal the special rules applicable to unused capital losses incurred before 1970, since taxpayers will have had 17 years to use these losses to reduce taxable income, and the special rules add complexity to individual tax forms.

Explanation of Provision

The special treatment applicable to capital losses sustained before 1970 is repealed.

Effective Date

The provision applies to the deduction of capital losses against ordinary income for taxable years beginning after December 31, 1986.

Revenue Effect

This provision is estimated to have a negligible revenue effect.

[3] For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 859; S. Prt. 98-169, Vol. I (April 2, 1984), p. 820; and H. Rep. No. 98-861 (June 23, 1984), p. 1264 (Conference Report).

B. Excise Tax Provisions

1. Excise Tax on Sport Fishing Equipment and Financing of Sport Fish Restoration and Boating Safety Programs (secs. 1010-1016 of the Act and secs. 4041, 4081, 9503, and new sec. 9504 of the Code)[4]

a. Revenue Provisions

Prior Law

Excise tax on fishing equipment

An excise tax equal to 10 percent of sales price is imposed on the first sale of certain fishing equipment. Under prior law, this tax was imposed on fishing rods, creels and reels, and on artificial lures, baits, and flies (including parts and accessories) sold by the manufacturer, producer, or importer thereof (Code sec. 4161(a)).

Amounts equivalent to the revenues from the 10-percent excise tax on fishing equipment are appropriated (based on the prior fiscal year's tax receipts) to the States in partial reimbursement of costs they incur in approved fish restoration and management projects, discussed below under the explanation of the sport fish restoration program (formerly referred to as the Dingell-Johnson fund program).

Time for payment of tax

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

Although most Federal excise tax returns are filed on a quarterly basis, Treasury regulations generally require monthly, or semimonthly, payment of tax (Treas. Reg. sec. 48.6302(c)-1). If a taxpayer is liable in any month for more than $100 of manufacturers excise tax, the taxpayer must deposit the amount on or before the last day of the next month at an authorized depository or at the Federal Reserve Bank serving the area in which the taxpayer is located.

If a taxpayer has more than $2,000 in manufacturers excise tax liability for any month of a preceding calendar quarter, these taxes must be deposited for the following quarter (regardless of amount)

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[4] For legislative background of these provisions, see: H.R. 2163 as reported by the House Committee on Ways and Means, H. Rep. No. 98-133, Pt. 2 (July 1, 1983) pp. 1-20; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, secs. 813-820; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 737-755; and H. Rep. No. 98-861 (June 23, 1984), pp. 1244-48 (Conference Report).

on a semimonthly basis. These taxes generally must be deposited by the ninth day following the semimonthly period for which they are deposited.

Under prior law, the general excise tax payment rules applied to the fishing equipment excise tax.

Taxes on motorboat fuels

Taxes at a rate of 9 cents per gallon are imposed on gasoline and special motor fuels used in motorboats. Under prior law, for fiscal years 1983 through 1988, up to $45 million per year (but not to exceed a total balance of $45 million in the fund at any time) of the revenue from these taxes was to be transferred into the National Recreational Boating Safety and Facilities Improvement Fund (the "Boating Safety Fund"). The balance, if any, of these revenues was transferred to the Land and Water Conservation Fund.

Import duties on fishing equipment and yachts and pleasure craft

Duties at varying rates are imposed on the importation of specified articles of fishing equipment (19 U.S.C. 1202). Duties also are imposed on the importation of certain yachts and pleasure craft (19 U.S.C. 1202). Revenues from these import duties were deposited in the general fund of the Treasury under prior law.

Reasons for Change

Excise tax on sport fishing equipment

Congress believed that the 10-percent excise tax on fishing equipment should be expanded to cover other sport fishing equipment so that all purchasers of such equipment will contribute to the financing of the Federal-State sport fish restoration program. However, Congress believed that a reduced rate of tax was appropriate in the case of certain articles (generally those articles selling for higher prices). Congress decided to impose the tax at a special three-percent rate on electric outboard boat motors, which are used primarily in sport fishing. Further, Congress decided to impose the tax at this special three-percent rate on certain fishfinders and to limit the maximum tax on any fishfinder to $30 because these devices may be used both as depth finders (navigational aids) and as devices for locating fish.

In expanding the types of articles subject to the fishing equipment excise tax, Congress was concerned about reports that domestic producers of fishing equipment had been disadvantaged by the prior-law method of imposing tax at the manufacturer or importer level. Specifically, Congress understood that some importers of fishing equipment were able to reduce the sales price on the first sale after importation (and hence the amount of tax) to an artificially low level, resulting in their receiving an unfair advantage over domestic producers. To provide equity among all taxpayers, Congress determined that special rules reimposing the tax on subsequent sales to related parties to the manufacturer or importer were appropriate in certain cases.

Congress also was concerned that, because of the seasonal nature of sport fishing equipment sales, expansion of this tax might cause cash flow difficulties for manufacturers who sell directly to retailers pursuant to extended credit terms. Accordingly, Congress decided to excuse payors of the excise tax on sport fishing equipment from deposit requirements generally applicable to payors of manufacturers excise taxes. Congress stated, however, in taking this action, that the action was not to be viewed as a precedent for taking similar action with respect to other excise taxes.

Additional revenue sources for sport fish restoration program

Congress determined that there was a need for additional revenues for the Federal-State sport fish restoration program beyond the amount available from the expanded fishing equipment excise tax. In addition to the revenues from the expanded excise tax on sport fishing equipment, Congress decided to provide for transfer of revenues from the existing import duties on fishing equipment and on yachts and pleasure craft to finance the sport fish restoration program. Further, Congress concluded that the revenues from the existing excise taxes on motorboat fuels should be reallocated so that the excess of such revenues over the $45 million per year allocated to the Federal boating safety program (with the exception of the first $1 million of such excess) also should be allocated to the sport fish restoration program.

Finally, Congress stated that it found persuasive arguments that inadequate State fisheries budgets have necessitated reductions in staff and programs. State fishery agencies collectively have indicated a pressing need for over $162 million per year in additional revenue to manage adequately the nation's recreational fishery resources. Congress, in establishing this expanded funding source, intended that the new revenues be added to existing State fishery program funds available from traditional sources and not be used as a substitute therefor.

Explanation of Revenue Provisions

Expansion of articles subject to 10-percent tax

The Act expands the articles of sport fishing equipment subject to excise tax at a 10-percent rate, and classifies the articles into five main categories.

Fishing rods and poles and fishing spear guns (and component parts)

Fishing rods and poles subject to tax include any tube or shaft-like device made of natural, synthetic, or other material that is designed to cast, troll, or otherwise present a bait or lure to fish. It was not the intention of Congress to tax bamboo poles that are not designed or intended for use in fishing; however, any pole intended for attaching a fishing line, to or through, is considered to be a fishing rod or pole. "Component parts" means rod handles, guides, reel seats, blank rods, tip-tops, ferrules, or any other devices that are designed to be attached to such poles or rods for use in fishing.

Fishing reels subject to tax include any mechanical device that is designed for dispensing and retrieving fishing line. The term includes reels used in fly fishing and also reels or spools employed for dispensing and retrieving the line attached to arrows and spears used in fishing.

Fly fishing lines and other fishing lines not greater than 130-pounds test subject to tax includes all lines, either monofilament, multifilament, synthetic, organic, or inorganic, including metal lines, that are designed for the purpose of attaching lures, hooks, flies, bobbers, sinkers, and any other item of terminal tackle, including lines to attach items of terminal tackle to one another, such as leaders. Fishing lines over 130-pounds test (i.e., lines able to suspend a 130-pound weight without breaking or stretching more than five percent of line length while suspending that weight) are not taxable under the Act. This limitation was included because Congress understood that commercial fishermen primarily use fishing line greater than 130-pounds test, while sport fishermen generally use line equal to or less than 130-pounds test.

Fishing spears subject to tax include any tube or shaft-like device ending in a sharp tip and designed for the purpose of spearing fish. A taxable spear gun is any device designed for propelling a shaft or tube-like item through the water for the purposes of spearing fish. A fishing spear tip is any device designed to be attached to a shaft or tube-like device that ends in one or several sharp tips.

Articles of terminal tackle

Articles of terminal tackle subject to the 10-percent tax include, but are not limited to:

(*1*) *Leaders*, i.e., articles used for attaching the end of a fishing line to a hook or lure or any other device of terminal tackle (a leader may include, but is not limited to, fishing lines, swivels, and snaps);

(*2*) *Artificial lures*, i.e., all artifacts (from whatever materials made) that simulate an article considered edible to fish or that otherwise are intended to induce a fish to attempt to confront, swallow, bite, or consume said device, and that are designed to be attached to a line (a lure usually includes one or more attached hooks);

(*3*) *Artificial baits*, i.e., any baits that simulate an article considered edible to fish and that are designed to be attached to a hook or lure (but not including preserved packaged natural baits);

(*4*) *Artificial flies*, i.e., hooks to which feathers, beads, lead, or other items are attached to make said items resemble insects or other organisms considered edible to fish and that are designed to be attached to a fishing line, leader, swivel, or snap;

(*5*) *Fishing hooks*, i.e., any curved or bent metallic device that terminates in a sharp point for the purpose of catching, holding, or pulling fish or fishing bait;

(*6*) *Bobbers*, i.e., any device used as a means to suspend a fishing line or lure in the water column, or that can be used to track visually the location and status of fishing line and associated hooks and bait;

(*7*) *Sinkers*, i.e., devices wholly or in part made of lead or other metallic substances designed to attach to fishing lines or items of terminal tackle with the intention of causing the terminal tackle to descend into the water column;

(*8*) *Snaps*, i.e., a catch, clip, or fastening device, that is designed at one end to tie onto the end of a fishing line and to attach, by means of a clasp at the other end, to articles of terminal tackle;

(*9*) *Drayles*, i.e., any articles made, wholly or in part, of lead or other metallic substances that can be tied or otherwise attached to the end of a fishing line to which is attached leaders or other items of terminal tackle, and that is designed to be trolled behind a boat, so that the line or terminal tackle descends into the water column; and

(*10*) *Swivels*, i.e., devices that are designed so that fishing line may be attached to either end, in order to permit the ends of the fishing line to pivot freely.

Tackle boxes

The Act imposes the 10-percent excise tax on sport fishing equipment on tackle boxes, i.e., all portable containers of whatever material made that are primarily designed or intended to be used as items in which to store or organize fishing paraphernalia such as hooks, lures, flies, sinkers, bobbers, etc., until such time as these items are placed on the fishing line, rod, or reel.

Certain fishing supplies and accessories

The following fishing supplies and accessories are subject to the 10-percent excise tax:

(*1*) *Fish stringers*, i.e., articles designed for or sold as devices for attaching fish through the mouth, including devices consisting of a series of metal or plastic clips as well as cords consisting of a ring and threader connected by a cord;

(*2*) *Creels*, i.e., portable containers designed for storing and carrying fish from the time they are caught until such time as they are removed from the container for consumption or preservation;

(*3*) *Bags, baskets, and other containers designed to hold fish*, including such items as collapsible baskets or similar devices that are designed to be hung over the side of the boat to keep fish captive and alive in the water;

(*4*) *Portable bait containers*, i.e., any device designed as an article to hold or transport bait such as minnow buckets and grasshopper cages, or any other device designed specifically to hold worms, insects, frogs, etc., to be used in connection with fishing activities;

(*5*) *Fishing vests*, i.e., garments designed for storing various lures, flies, hooks, and other fishing paraphernalia (the term fishing vest includes vests with flotation capacity, but not those vests that are intended solely as flotation devices);

(*6*) *Landing nets*, i.e., articles consisting of a handle connected to a hoop, which hoop is covered by a bag-type net, and which articles are designed primarily for scooping a hooked fish out of the water and into a vessel or onto shore;

(*7*) *Gaff hooks*, i.e., devices consisting of a handle and hook for holding or lifting fish into a vessel once they are brought to the boat on the end of a fishing line;

(*8*) *Fishing hook disgorgers*, i.e., any implement designed for use in removing fishing hooks from the mouth, gill, arches, or stomach of fish; and

(*9*) *Dressing for fishing lines and artificial flies*, i.e., any substance designed to be applied to fishing lines or artificial flies to enhance the flotation of the line or fly or otherwise designed to attract fish to the artificial fly.

Fishing tip-ups and tilts

Fishing tip-ups and tilts subject to the excise tax are defined as devices consisting of such parts as a spool on a spindle and a spring-mounted flag on opposite ends of a vertical pole with cross members to support the pole over a hole in ice, or any other such device designed to alert a fisherman when a fish is either hooked or in the process of attempting to eat the bait on a hook or bite a bait or lure.

Other fishing equipment

Certain other types of fishing equipment also are subject to the 10-percent tax, including—

(*1*) *Fishing rod belts*, i.e., articles that fasten around or near the waist and that are designed for placing the butt end of a rod or pole in a cup-like depression to aid in holding or handling of a rod or reel.

(*2*) *Fishing rod-holders*, i.e., devices that may by portable and either can be inserted into beaches or clamped onto boats and that hold a rod or pole in a stationary position relative to the boat or beach.

(*3*) *Fishing harnesses*, i.e., articles worn by an angler to transmit muscular power to the rod or to absorb strain. Fishing harnesses generally are made of canvas, leather, and/or similar materials, and have straps with devices that can be fastened to the reel and/or sockets into which the rod butt may be seated.

(*4*) *Fish fighting chairs*, i.e., heavily built chairs usually designed to have a footrest, rod holders, and a swivel base attached that generally are installed permanently in a suitable fishing boat for the purpose of fighting deep sea fish with rod and reel.

(*5*) *Fishing outriggers*, i.e., devices attached to a boat consisting of braced rods or tubes with a means for attaching fishing line out and away from the boat for trolling purposes in such a way that when the fish strike the bait, the line is released so that the fish may be fought directly with rod and reel.

(*6*) *Fishing downriggers*, i.e., devices used for submerging and lowering fishing line and bait down and away from a boat while trolling (a downrigger generally consists of a boom and reel attached to the boat supporting a cable and weight with a means for attaching fishing line in such a way that when a fish strikes the trolled bait, the line is released from the weight so that the fish may be fought directly with rod and reel).

Three-percent rate on electric outboard boat motors and certain fish finders

The Act imposes the excise tax on sport fishing equipment at a special three-percent rate on electric outboard boat motors and on certain fishfinders. The amount of tax imposed on taxable fishfinders may not exceed $30 per fishfinder. Fishfinders subject to tax generally include all sonar devices suitable for finding fish. An exemption is provided, however, for sonar devices that are graph recorders, digital type devices, or meter readout devices. In addition, any combination sonar device that includes a meter readout or graph recorder is not subject to tax. Other combination devices (e.g., a combination flasher and digital device) are taxable.

Treasury regulations

Congress recognized that certain sonar devices and utility boxes (tackle boxes) are primarily designed or intended to be used for purposes other than sport fishing. For instance, sonar devices may determine the depth of water under a boat and the type of water bed as an aid to navigation and safe boating. These utility boxes may be used to store a wide range of items, such as tools, that are unrelated to catching fish. Congress intended that, pursuant to Treasury regulations, articles similar to fishfinders and tackle boxes that are not primarily designed or intended to be used for sport fishing will be delineated to ensure that, to the extent practicable, they are not subject to tax. Congress anticipated that these regulations will provide that articles advertised as fishfinders or tackle boxes will be taxable as such.

Reimposition of tax in certain cases

Under the Act, the excise tax on sport fishing equipment will continue to be imposed at the manufacturer's (or importer's) level. However, the Act provides that tax will be imposed a second time on the sale of a taxable article by any wholesale distributor or retailer who (1) is a related party to the manufacturer or importer of the article sold, and (2) acquires the article from an unrelated party (i.e., from a party other than the manufacturer or importer). In cases where the tax is imposed a second time on any article, a credit for prior tax paid is available, provided the wholesale distributor or retailer can document the amount of tax that actually was paid previously. This documentation requirement generally will be considered as satisfied only by submission of copies of actual records of the party that previously paid the tax. For purposes of these rules, the term related party generally includes parties described in Code section 267 (as amended by the Act).

Congress also was concerned that certain manufacturers and importers of taxable sport fishing equipment were engaged in arrangements that were not covered under the related party rules of prior (and present) law, but that do not represent true arm's-length transactions. Rather these transactions are in substance (if not form) dealings between related parties or are transactions conducted primarily to reduce Federal excise tax. Therefore, the Act provides that, except as provided in Treasury Department regulations, certain sales are not to be treated as taxable first sales by a manufacturer or importer (in addition to sales so treated under the law before enactment of the Act). Rather, in these cases, the tax is imposed on a later sale. Congress intended that Treasury regulations generally will provide that a sale by a manufacturer or importer is not treated as a taxable first sale unless the party selling the article (1) conducts all manufacturing or importation transactions and related documentation in its own name; (2) assumes risks of late delivery and loss and pays freight, insurance costs, and customs duties (in the case of importers); (3) has on its payroll the employees who are engaged in the manufacturing process conducted by it, or who are engaged in all aspects of the importation or other distribution of articles processed by it, including dealings with manufacturers with regard to quantity, quality control, design specifications and shipping; (4) finances the further manufacture or purchase of previously manufactured articles on its own account; (5) maintains inventories of the articles in its own name; and (6) earns normal profits (determined by reference to industry standards) on its sales that are to be treated as taxable first sales.

Time for payment of excise tax on sport fishing equipment

The Act excuses all manufacturers and importers from the deposit requirements generally applicable to payors of the manufacturers excise taxes in the case of the excise tax on sport fishing equipment. Under the Act, the sport fishing equipment excise tax will be payable in full on the date established by the Treasury Department for filing of the quarterly returns of that tax.

Transfer of revenues from import duties on fishing tackle and on yachts and pleasure craft

An amount equivalent to the revenues received from the import duties on fishing equipment and on yachts and pleasure craft is dedicated to the sport fish restoration program, rather than being retained in the general fund of the Treasury.

Reallocation of motorboat fuels tax receipts

Revenues from the existing excise taxes on gasoline and special motor fuels used in motorboats are reallocated between the sport fish restoration program, the Federal boating safety program, and the Land and Water Conservation Fund. This reallocation is explained more fully in Item b., "Trust Fund Provisions".

Effective Date

These revenue provisions of sections 1010-1016 of the Act became effective on October 1, 1984.

Revenue Effect

These revenue provisions of sections 1010-1016 of the Act are estimated to increase net fiscal year budget receipts by $12 million in 1985, $13 million in 1986, $14 million in 1987, $14 million in 1988, and $15 million in 1989.

b. Trust Fund Provisions

Prior Law

Prior law did not provide an established trust fund for the sport fish restoration and Federal boating safety programs. Instead, these programs were funded by an appropriation from the general fund of the Treasury of amounts equivalent to specific tax revenues (in the case of the sport fish restoration program) or by appropriation to a special "fund" not having the status of an established trust fund (in the case of the Federal boating safety program).

Sport fish restoration program

The Act of August 9, 1950 (formerly referred to as the Dingell-Johnson Act) provided for cooperation between the Federal Government and State fish and game departments. Although the Act did not establish a separate fund for sport fish restoration purposes under prior law, appropriations for this purpose were linked to specific tax revenues. Limits were placed on State expenditures of Federally appropriated funds until the State had passed laws governing the conservation of fish and the State satisfied other requirements.

An amount equivalent to revenues from the 10-percent excise tax on fishing equipment was authorized to be appropriated (under 16 U.S.C. sec. 777b) to carry out fish restoration and management projects. The appropriation was based on the prior fiscal year's tax receipts; the appropriation for any fiscal year continued to be available for the succeeding fiscal year. If the amount apportioned to any State was unexpended or unobligated at the end of the period for which it was available, this amount was made available for expenditure by the Secretary of the Interior on the research program of the Fish and Wildlife Service.

To receive a portion of these appropriations, a State was required to submit to the Secretary of the Interior a project for fish restoration. Amounts were appropriated to reimburse States for up to 75 percent of the cost of approved projects. Approved projects included research into problems of fish management and culture, surveys and inventories of fish populations, restocking waters with game fishes according to natural areas, and acquisition and improvement of fish habitats that provided access for public use. The amount of assistance for each of these types of programs was determined by a statutory formula.

A portion of each annual appropriation was available to the Secretary of the Interior to defray expenses of administering the program and of aiding in the formulation, adoption, or administration of any compact between two or more States for the conservation and management of migratory fish in marine or fresh waters.

Under prior law, the remainder of the appropriation was apportioned to the States as follows:

(1) 40 percent in the ratio that the area of each State, including coastal and Great Lakes waters, bore to the total area of all the States; and

(2) 60 percent in the ratio that the number of persons holding licenses to fish for sport or recreation in the State in the second fiscal year preceding the fiscal year for which the apportionment was made bore to the number of such persons in all the States.

No State was permitted to receive less than one percent or more than five percent of the total amount apportioned. Puerto Rico, Guam, American Samoa, the Commonwealth of the Northern Mariana Islands, and the Virgin Islands could also receive limited amounts of these revenues.

National Recreational Boating Safety and Facilities Improvement Fund ("Boating Safety Fund")

The National Recreational Boating Safety and Facilities Improvement Fund ("Boating Safety Fund") was enacted on October 14, 1980 (P.L. 96-451) (the "1980 Act") to provide a source of funding for Federal recreational boat safety and facilities improvement projects. Before this time, all funds attributable to the excise taxes on fuels used in motorboats were transferred periodically into the Land and Water Conservation Fund.

Under the 1980 Act, the Secretary of the Treasury was authorized to pay into the Boating Safety Fund certain amounts equivalent to the motorboat fuels taxes received on or after October 1, 1980, and before October 1, 1988. The aggregate amount transferred could not exceed $45 million for each of fiscal years 1983 through 1988. Additionally, the maximum amount permitted to be held by the Fund at any time could not exceed $45 million. Any excess motorboat fuels tax receipts were transferred into the Land and Water Conservation Fund, discussed below.

Amounts in the Boating Safety Fund were available, as provided in appropriation Acts, for carrying out the purposes of the Federal Boat Safety Act of 1971 (46 U.S.C. 1476). Under that Act, as amended in 1982 by the Highway Revenue Act, the Secretary of Transportation was provided authority to contract with the States to implement and administer boating safety programs. Approval of specific elements of a State program by the Secretary of Transportation was deemed to be a contractual obligation of the United States.

Under section 26 of the Federal Boat Safety Act, the Secretary of Transportation could allocate and distribute amounts from the Boating Safety Fund to any State that had a State recreational boating safety and facilities improvement program if that program met certain standards and the State provided matching funds. Under prior law, one-third of the revenue available for allocation and distribution was allocated for recreational boating safety programs and two-thirds were allocated for recreational boating facilities improvement programs.

Land and Water Conservation Fund

In 1964, Congress established the Land and Water Conservation Fund as a separate account in the Treasury, effective January 1,

1965. Prior law (16 U.S.C. 460-465) provided for deposit in the Land and Water Conservation Fund of amounts equivalent to the 9-cents-per-gallon taxes on gasoline and special motor fuels used in motorboats (to the extent these revenues exceeded the amount transferred to the Boating Safety Fund) and certain other, nontax, revenues.

The general purposes of the Land and Water Conservation Fund are (1) to provide funds for Federal assistance to the States in planning, acquisition, and development of needed land and water areas and facilities for conservation purposes, and (2) to provide funds for the Federal acquisition and development of certain other lands and areas. Monies in the Fund are available for expenditures as provided in appropriation Acts. Not less than 40 percent of annual appropriations may be used for Federal purposes; these include activities and programs of the Bureau of Land Management, the Forest Service, the Fish and Wildlife Service, and the National Park Service. The remainder of monies in the Fund are apportioned among the States on the basis of statutory formulae and criteria.

Reasons for Change

Congress determined that the additional revenues provided under the Act for support of the Federal-State sport fish restoration and boating safety programs should be administered through a special fund established for that purpose. Congress concluded that such a fund should be a regular trust fund and codified in the Trust Fund Code of the Internal Revenue Code for efficiency of administration and oversight. This action conforms to the prior Congressional policy of incorporating trust funds (e.g., Airport and Airway, Highway, and Black Lung Trust Funds) into the Internal Revenue Code.

In reviewing funding of these programs, Congress concluded that up to $45 million per year (for fiscal years 1983-1988) of revenues from the taxes on motorboat fuels should continue to be dedicated to Federal-State boating safety programs. However, to provide additional revenues for sport fish restoration programs, Congress determined that motorboat fuels tax revenues in excess of the amounts transferred to the boating safety program (with the exception of the first $1 million per year of such excess) should be allocated to the sport fish restoration program rather than to the Land and Water Conservation Fund as under prior law. The first $1 million of these revenues will continue to be deposited in the Land and Water Conservation Fund.

Explanation of Trust Fund Provisions

Establishment of Aquatic Resources Trust Fund

In general

The Act establishes a new trust fund, The Aquatic Resources Trust Fund (known as the Wallop-Breaux Fund), to be administered by the Secretary of the Treasury. The new Wallop-Breaux Fund expands and combines funding for the prior sport fish restoration and boating safety programs into a single Trust Fund. The

Trust Fund consists of two accounts, the Sport Fish Restoration Account and the Boating Safety Account, described below.

Under the Act, amounts equivalent to the following revenues are appropriated to the Aquatic Resources Trust Fund:

(1) Revenues from the expanded excise tax on sport fishing equipment (both the 10-percent and the 3-percent portions);

(2) Revenues from the 9-cents-per-gallon excise taxes on gasoline and special motor fuels used in motorboats (other than $1 million of those revenues that will continue to be transferred to the Land and Water Conservation Fund); and

(3) Import duties imposed on fishing equipment and on yachts and pleasure craft.

Sport Fish Restoration Account

The prior sport fish restoration program is replaced by the expanded program provided under the new Sport Fish Restoration Account. This expanded program is financed by trust fund revenues attributable to (1) the excise tax on sport fishing equipment, (2) motorboat fuels taxes (to the extent these revenues exceed the amount transferred to the Boating Safety Account and the Land and Water Conservation Fund),[5] and (3) import duties on fishing equipment and on yachts and pleasure craft.

The expenditure purposes established for the Sport Fish Restoration Account are those purposes established for the existing sport fish restoration program, as amended by the Act. Expenditure purposes are limited, however, to those provided by law as of October 1, 1984. Specifically, monies in the account may be expended, subject to appropriation acts,[6] for the purpose of restoring and managing all species of fish that have material value in connection with sport or recreation in the marine and/or fresh waters of the United States, including—

(1) Such research into problems of fish management and culture as may be necessary for efficient administration of fish resources;

(2) Acquisition of such information as is necessary to guide and direct the regulation of fishing by law, including the extent of the fish population, the drain on the fish supply from fishing and/or natural causes, the necessity of legal regulation of fishing, and the effects of any measures of regulation that are applied;

(3) Formulation and adoption of plans for restocking waters with food and game fish according to natural areas or districts to which such plans are applicable, together with the acquisition of such facts as are necessary to the formulation, execution, and testing of such plans;

(4) Selection and improvement of areas of water or land adaptable as hatching, feeding, or breeding places for fish, including ac-

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[5] Under the Act, amounts equivalent to the revenues derived from the excise taxes on motorboat fuels are allocated first to the Land and Water Conservation Fund (in an amount not exceeding $1 million), and second, to the Boating Safety Account (in an amount not exceeding $45 million), with the excess being allocated to the Sport Fish Restoration Account. By contrast, under prior law, these amounts were transferred first to the Boating Safety Fund (in an amount not exceeding $45 million), with the entire excess being transferred to the Land and Water Conservation Fund.

[6] The permanent appropriations provision under the Act of August 31, 1951 is retained by the Act; therefore, that provision governs expenditures from the Sport Fish Restoration Account, as successor to the sport fish restoration program of prior law.

quisition by purchase, condemnation, lease, or gift of such areas as are suitable therefor, and the construction thereon of such improvements as may be necessary to make them available for these purposes;

(5) Acquisition, development, renovation, or improvement of facilities (and auxiliary facilities necessary to ensure safe use of such facilities) that create, or add to, public access to the waters of the United States for boating purposes;

(6) Aquatic resource education programs for increasing public understanding of the Nation's water resources and associated aquatic life forms; and

(7) Subject to a percentage limitation contained in the Act, for administration of the sport fish restoration program by the Secretary of the Interior.

Monies in the Account will remain available until spent.

Boating Safety Account

The National Recreational Boating Safety and Facilities Improvement Fund is replaced by a new Boating Safety Account in the Aquatic Resources Trust Fund. As under the prior Boating Safety Fund, the Boating Safety Account is funded by an amount equivalent to a portion of the revenues from the excise taxes on motorboat fuels. This funding is subject to the same maximum amount limitations as applied under prior law.

The expenditure purposes established for the Boating Safety Account are the same as those established for the prior Boating Safety Fund, with certain amendments. Expenditure purposes are limited, however, to those provided by section 30 of the Federal Boat Safety Act of 1971, as of October 1, 1984. Specifically, monies in the Account may be expended, subject to appropriation Acts, as follows:

(1) Two-thirds of the amount allocated to the Account in any fiscal year (i.e., up to $30 million) for State boating safety programs; and

(2) One-third of the amount allocated to the Account (i.e., up to $15 million) for the operating expenses account of the Coast Guard (including the Coast Guard Auxiliary) to defray the cost of services provided by it for recreational boating safety.

The State boating safety program purposes eligible for funding from the account are—

(1) Providing facilities, equipment, and supplies for boating safety education and law enforcement, including purchase, operation, maintenance, and repair;

(2) Training personnel in skills related to boating safety and to the enforcement of boating safety laws and regulations;

(3) Providing public boating safety education, including education programs and lectures, to the boating community and the public school system;

(4) Acquiring, constructing, or repairing public access sites used primarily by recreational boaters;

(5) Conducting boating safety inspections and accident investigations;

(6) Establishing and maintaining facilities for emergency or search-and-rescue assistance; and

(7) Establishing and maintaining waterway markers and other appropriate aids to navigation.

Monies in the Account will be available, subject to appropriations Acts, for expenditure by the Secretary of Transportation pursuant to that Secretary's contract authority, and will remain available until spent.

Land and Water Conservation Fund

An amount not exceeding $1 million per fiscal year of the revenues attributable to the excise taxes on gasoline and special fuels used in motorboats will continue to be transferred to the Land and Water Conservation Fund. No other amendments are made by the Act to that Fund.

Effective Date

These trust fund provisions of the Act became effective on October 1, 1984.

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c. Amendments to the Federal Aid to Sport Fish Restoration Act

The Act includes several amendments to the Sport Fish Restoration Act of 1950 (the Act of August 9, 1950).

First, the Act provides that all funds accruing to the sport fish restoration program are to be allocated equitably between projects that benefit marine sport fisheries and projects that benefit freshwater sport fisheries, since the funds used are being collected from both marine and freshwater boaters and fishermen. Congress recognized that, since all coastal States do not require marine fishing licenses, an exact calculation of the proper allocation was virtually impossible. Congress intended, however, that the procedures used will be based on the most reliable and uniformly derived estimates of salt water anglers, such as the National Survey of Fishing, Hunting and Wildlife Associated Recreation published by the U.S. Fish and Wildlife Service. Congress also recognized that it was impracticable for States to design projects that would meet the allocation requirements exactly and intended that the guidelines allow for variance from the allocation formulae on a yearly basis as long as the States make a good faith effort to allocate the funds properly over a reasonable multi-year period, such as three years.

The Act amends section 3 of the 1950 Act to incorporate the authorization of appropriations of sums equal to the motorboat fuels taxes (less appropriations to the new Boating Safety Account and the Land and Water Conservation Fund), as well as the import duties imposed on fishing tackle, yachts, and pleasure craft, and the revenues from the expanded tax on sport fishing equipment.

The Act amends section 4 of the 1950 Act by reducing the amount available to the Department of the Interior for administration of the program from eight percent to six percent. Congress believed that the administrative costs of the program reflect responsibilities that are more or less fixed, and that a smaller percentage of a larger fund should, therefore, provide for adequate administration and oversight.

The Act amends section 6 of the 1950 Act to allow the Secretary of the Interior to agree to assume 75 percent of the cost of qualified projects over a period of years, subject to the availability of funds. This provision is designed to allow the States to schedule the payments for large scale projects over a period of years.

The Act also contains two amendments to section 8 of the 1950 Act. The first amendment requires each State to allocate a minimum of 10 percent of its annual allocation to projects that improve public access to the waters of the U.S. or improve the suitability of those waters for recreational boating. Congress intended by this provision to ensure that a portion of the funds derived from the motorboat fuels taxes is used for projects that directly benefit the people who pay the tax. Thus, it was the intent of the Congress that these projects be designed to accommodate motorboats. While it is obvious that not every such project can be designed for the most powerful of boats, it was the intent of the Congress that these projects accommodate boats with common horsepower ratings.

Congress intended that a broad range of access facilities and associated amenities qualify for construction under this set-aside. Examples of such projects include, but are not be limited to, launching facilities, such as ramps and boat lifts, docking facilities, breakwaters, and fishing and boating lakes and ponds (provided power boats are permitted). Congress also intended that these funds be available for such additional amenities as fish cleaning stations, restrooms, trash receptacles, and parking areas. Engineering costs, as well as the costs of environmental assessment and permit applications, also may be included in the project costs. Congress did not intend that these set-aside funds be the only source of public access, acquisition, construction, repair, or maintenance. (Access - and safety-related facilities also may be constructed with boating safety funds.) If any State does not utilize the set-aside for access, the unused funds will be available for subsequent expenditure.

The second amendment to section 8 of the 1950 Act authorizes the use of up to 10 percent of a State's allocation under that Act for aquatic resource education programs. The purpose of this provision is to encourage programs that increase public understanding of the nation's water resources and aquatic life forms. Congress intended that these funds be available for a broad range of education programs, including programs designed for presentation to civic groups and volunteer organizations as well as programs designed for educational institutions.

d. Amendments to the Federal Boat Safety Act

The Act restates the policies and purposes of the Federal Boat Safety Act of 1971 (P.L. 92-75, the "1971 Act") and makes several other amendments to that Act. The Act retains the prior-law authorization for the Secretary of Transportation to enter into contracts to implement boating safety programs, but eliminates the authority for facilities programs.

Two-thirds of the money in the Boating Safety Account is made available for State boating safety programs. The Secretary of Transportation is required to establish guidelines prescribing purposes for which funds available for the boating safety programs may be used. These purposes include (1) the provision of facilities, equipment, and supplies for boating safety education and law enforcement; (2) training and education in boating safety and the enforcement of boating safety laws; (3) the acquisition, construction, and repair of public access sites used primarily by recreational boaters; (4) providing boat numbering or titling programs; (5) conducting boating safety inspections and accident investigations; (6) establishing and maintaining State capabilities to provide emergency research and rescue assistance; and (7) establishing and maintaining aids to navigation. Congress intended that the types of navigation aids covered by the State programs would include devices that mark State waters, marinas, and other areas of concern to each local interest and that do not necessarily replace the general aid to navigation functions performed by the Coast Guard.

In addition, one-third of the money in the Account is made available to the Secretary of Transportation for expenditure each year out of the operating expenses account of the Coast Guard for services provided by the Coast Guard for recreational boating safety, including services provided by the Coast Guard Auxiliary.

Finally, the Act amends section 202 of the Recreational Boating Fund Act of 1980 (46 U.S.C. 1479a) to eliminate references to boating facilities programs, to redesignate the Fund as the Boating Safety Account (in the Aquatic Resources Trust Fund), and to make a technical amendment to the 1982 Highway Revenue Act extending the sunset for expenditures out of the revised Account from March 31, 1984, to March 31, 1989.

2. Expansion of Excise Tax on Certain Arrows (sec. 1017 of the Act and sec. 4161(b) of the Code) [7]

Prior Law

An 11-percent manufacturers excise tax is imposed on the sale by a manufacturer or importer of any bow which has a draw weight of 10 pounds or more. Under prior law, this tax also was imposed on the sale of arrows which measured 18 inches overall or more in length (Code sec. 4161(b)). Revenues from this tax are appropriated to the Federal Aid to Wildlife Program (Pittman-Robertson fund) for support of State wildlife programs.

Reasons for Change

Congress determined that arrows used by crossbow hunters should be subject to tax because these hunters benefit from the Federal Aid to Wildlife Program as do hunters using other types of bows.

Explanation of Provision

Under the Act, the excise tax on arrows is expanded to apply to arrows fewer than 18 inches in overall length which are suitable for use with a taxable bow (e.g., with crossbows).

Effective Date

This provision became effective with respect to arrows sold after September 30, 1984.

Revenue Effect

This provision is estimated to increase budget receipts by a negligible amount each year.

[7] For legislative background, see: H.R. 2163 as reported by the House Committee on Ways and Means, sec. 321; H. Rep. No. 98-133, Pt. 2 (July 1, 1983), p. 21; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 821; S. Prt. 98-169, Vol. I (April 2, 1984), p. 755; and H. Rep. No. 98-861 (June 23, 1984), p. 1248 (Conference Report).

3. Certain Helicopter Uses Exempt from Aviation Excise Taxes (sec. 1018 of the Act and secs. 4041(*l*) and 4261(e) of the Code) [8]

Prior Law

Helicopters are exempt from the aircraft fuels and transportation taxes when employed in qualified activities. Under prior law, this exemption was limited to activities involving hard mineral resources or forestry that did not involve the use of Federally aided airports or Federal airway facilities. Qualified hard mineral resource activities included transporting individuals, equipment, or supplies in the exploration for, or the development or removal of, hard mineral resources. Qualified forestry activities included planting, cultivating, cutting, transportating of, or caring for, trees.

Prior law provided no exemption for natural resource operations involving oil and gas exploration.

Reasons for Change

Revenue from the airway excise taxes is dedicated to the Airport and Airway Trust Fund from which funds are expended for development and maintenance of the Federal airway system. Congress had provided previously that helicopters engaged in hard mineral and timber resource operations should not be subject to these taxes when the helicopters do not use the Federal airway system. After further review, Congress concluded that these exemptions from the airway fuels and ticket taxes should not distinguish between types of natural resource development operations in cases where the Federal airway system is not used.

Explanation of Provision

The Act expands the prior-law exemptions from the excise taxes on aviation fuels and transportation to include helicopters engaged in the exploration and development of oil and gas as well as hard mineral resource and forestry activities.[9] As under prior law, the exemptions do not apply to helicopters that depart from or arrive at heliports or airports that receive funds from the FAA airport development assistance programs or helicopters that follow FAA air navigation signals in their flight patterns.

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[8] For legislative background, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 823; S. Prt. 98-169, Vol. I (April 2, 1984), p. 758; and H. Rep. No. 98-861 (June 23, 1984), p. 1248 (Conference Report).

[9] The application of this provision to activities other than oil and gas exploration is unclear under the Act. It is anticipated that a technical amendment will be recommended clarifying that this exemption for oil and gas activities is coterminis with the exemption for hard mineral resource activities.

Effective Date

The extension of the exemptions from the aviation fuels and transportation excise taxes to oil and gas exploration and development became effective on April 1, 1984.

Revenue Effect

This provision is estimated to decrease net fiscal year budget receipts by $3 million in 1984, $4 million each in 1985 and 1986, $5 million in 1987, and $2 million in 1988.

4. Technical Amendments to the Hazardous Substance Response Revenue Act of 1980 (sec. 1019 of the Act and secs. 4661 and 4662 of the Code) [10]

Prior Law

The Hazardous Substance Response Revenue Act of 1980, enacted as Title II of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA), imposes excise taxes on petroleum and certain chemicals. The proceeds of these taxes are deposited in the Hazardous Substance Response Trust Fund (Superfund) for use in responding to releases of hazardous substances into the environment. The taxes imposed under present law are scheduled to terminate on September 30, 1985, or, if earlier, when the aggregate taxes collected exceeds $1.38 billion.

The excise tax on chemicals applies to the following 42 specifically enumerated substances:

Acetylene, Benzene, Butane, Butylene, Butadiene, Ethylene, Methane, Napthalene, Propylene, Toluene, Xylene, Ammonia, Antimony, Antimony trioxide, Arsenic, Arsenic trioxide, Barium sulfide, Bromine, Cadmium, Chlorine, Chromium, Chromite, Potassium dichromate, Sodium dichromate, Cobalt, Cupric sulfate, Cupric oxide, Cuprous oxide, Hydrochloric acid, Hydrogen fluoride, Lead oxide, Mercury, Nickel, Phosphorous, Stannous chloride, Stannic chloride, Zinc chloride, Zinc sulfate, Potassium hydroxide, Sodium hydroxide, Sulfuric acid, and Nitric acid.

In the case of butane and methane, the tax is imposed only if those substances are used other than as a fuel, in which case the person so using them is treated as the manufacturer. Another exemption is provided for certain chemicals that are used to produce fertilizer or that are directly applied to crops or cropland as fertilizer. These chemicals are nitric acid, sulfuric acid, ammonia, and methane used to produce ammonia which is then used for fertilizer purposes. The exemption applied under prior law if the manufacturer, producer, or importer of the chemicals either used these chemicals for fertilizer or sold them to a purchaser who either (1) used them for fertilizer or (2) sold them to a second purchaser who then used them for fertilizer. In the case of a sale for use, proposed regulations published by the Treasury Department on October 20, 1983, required the manufacturer, producer, or importer to obtain a certificate in which the purchaser agreed to use the chemicals for fertilizer and to notify the manufacturer, etc., if the chemicals were sold or were not used for fertilizer. In the case of a sale for resale, the proposed regulations required the manufacturer, pro-

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[10] For legislative background, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 824; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 760-762; and H. Rep. No. 98-861 (June 23, 1984), p. 1249 (Conference Report).

ducer, or importer to obtain a certificate in which the purchaser agreed to resell the chemicals to a second purchaser only for use by the second purchaser as fertilizer, and to obtain proof from the purchaser that the chemicals had been resold for fertilizer. In both cases, the manufacturer, producer, or importer remained liable for tax if the use for which the chemicals were sold was not made. If a substance on which the chemical tax had been paid was subsequently used in a fertilizer use, the user was entitled to a refund of the tax previously paid.

Under the proposed regulations, the addition of substances (such as toluene) to gasoline or the use of a light hydrocarbon stream which contains taxable chemicals (such as benzene, toluene, or xylene) to make gasoline was subject to tax as a use. Similarly, the creation of a metal compound (such as cupric sulfate) in a metal refining process gave rise to a tax on use when that substance was consumed in the refining process.

Reasons for Change

Congress believed that if the rules in the proposed regulations were not modified, the intended balance of the Superfund taxes between chemicals and petroleum would have been significantly altered. Similarly, Congress believed that the treatment in the proposed regulations of metal compounds existing temporarily during a refining processes could frustrate the intent of the original Act to exempt zinc, lead, and copper metals from tax. Finally, Congress believed the exemption process provided in 1980 for fertilizer had proven to be overly cumbersome and should therefore be simplified.

Explanation of Provision

The Act makes three amendments to the Hazardous Substance Response Revenue Act of 1980. First, the Act provides that when any of the 11 listed petrochemicals (i.e., the first 11 substances in the above list) subject to the chemical tax are used for the manufacture or production of motor fuel, diesel fuel, aviation fuel, or jet fuel, the chemical tax does not apply. (Of course, the excise tax on crude oil and imported petroleum products continues to apply even if the oil or products are used for motor fuels, etc.) Under this exception, an otherwise taxable substance is not subject to the chemical tax if it is (1) added to a qualified fuel, (2) used to produce another substance that is added to a qualified fuel, or (3) sold for either of the uses described in (1) or (2), above. For example, if a refiner or chemical plant operator produces butylenes in a cracking process and then converts those butylenes to methyl tertiary butyl ether or alkylate which is used as a motor fuel additive, no chemical tax will be imposed. If, however, a portion of the alkylate is used or sold to produce (for example) solvents, then tax will be imposed on a corresponding portion of the butylenes. Further, if isobutanes are used to produce tertiary butyl alcohol for use in a motor fuel, no chemical tax will be imposed.

Second, with regard to barium sulfide, cupric sulfate, cupric oxide, cuprous oxide, zinc chloride, zinc sulfate and lead oxide, the Act provides that the transitory existence of those substances during a smelting, refining or other extraction process does not give rise to a liability for the chemical tax. If a substance is removed from use in the refining process tax will be imposed. This would be true even if the substance is later reintroduced to the refining process.

The third amendment made by the Act relates to the manner in which the exemption for nitric acid, sulfuric acid, and ammonia used for fertilizer uses may be claimed. The Act permits manufacturers or producers of those substances to sell them free of tax if the material will ultimately be used for fertilizer purposes, with no limit on the number of tax-free results. The decision to claim the exemption may be made upon the purchaser's reasonable expectation that the material will be used in a fertilizer use. This expectation could be based, for example, on the fact that the material is to be sold to a farm cooperative. If the material is subsequently used for nonfertilizer purposes, the user will be taxed as if it were the manufacturer. If the manufacturer sells one of these substances to a person who he does not reasonably expect will use or resell them for fertilizer purposes, then the chemical tax will be imposed on that sale by the manufacturer.

Effective Date

These provisions were effective as if enacted as part of the Hazardous Substance Response Revenue Act of 1980.

Revenue Effect

These provisions are not anticipated to affect the revenue receipts that were originally estimated when Congress enacted the chemical and crude oil environmental excise taxes.

C. Estate and Gift Tax Provisions

1. Qualification of Certain Holding Company Stock for Installment Payment of Estate Tax (sec. 1021 of the Act and sec. 6166 of the Code) [11]

Prior Law

Qualification for installment payments

Estate tax attributable to certain interests in closely held businesses may be paid in installments over up to 14 years (interest only for four years followed by up to ten annual installments of principal and interest) (Code sec. 6166). A special four-percent interest rate is provided for the first $345,800 of tax (less the decedent's unified credit) (sec. 6601).

An estate is eligible for the installment payment provision if the value of the business interest included in the estate equals at least 35 percent of the value of the adjusted gross estate. Eligible business interests include interests in businesses operated as proprietorships, partnerships, or corporations. An interest in a corporation qualifies for the installment payment provision if (1) the corporation has 15 or fewer shareholders, or (2) the decedent owned 20 percent or more of the voting stock of the corporation.

Under prior law, only directly owned stock in a corporation actively engaged in a business operation was considered under the installment payment provision. A special rule permits attribution to a decedent of stock in an otherwise qualified corporation that is owned by certain family members; however, if this attribution provision is elected, the five-year deferral of principal and the special four-percent interest rate are not available.

Additionally, Treasury regulations took the position under prior law that the value of a trade or business carried on as a proprietorship included only the value of those assets of the decedent that were actually used in the trade or business. On the other hand, if the business were carried on as a partnership or a corporation, the value of the business was determined based upon the value of all partnership or corporate assets, even though a portion of the partnership or corporate assets were used for a purpose other than carrying on a trade or business. Treas. Reg. sec. 20.6166A-2(c)(2).

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[11] For legislative background of the provision see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 812; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), p. 1750; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 801; S. Prt. 98-169, Vol. I (April 2, 1984), p. 711; Senate floor amendment, 130 Cong. Rec. S. 4122 (April 9, 1984); and H. Rep. No. 98-861 (June 23, 1984), p. 1235 (Conference Report).

Acceleration of unpaid installments

Unpaid installments of tax are accelerated in certain circumstances. First, if cumulative dispositions of and withdrawals from the business equal 50 percent or more of the value of decedent's interest, all unpaid installments are accelerated. Redemptions of stock under section 303 (relating to income tax treatment of certain redemptions for payment of estate taxes) are not considered withdrawals for purposes of the acceleration rules if an amount equal to the redemption proceeds is used to pay Federal estate taxes on or before the due date of the first installment that becomes due after the date of the redemption (or, if earlier, one year after the redemption).

Second, all unpaid installments are accelerated if an estate has undistributed net income (UNI) in any year after the first installment is due unless the executor pays an amount equal to the UNI to reduce the amount of unpaid installments. Third, all unpaid installments are accelerated if payment of any installment is not made within six months after the due date of that installment.

Reasons for Change

The estate tax installment payment provision is intended to prevent the forced disposition of interests in active businesses solely to enable payment of Federal estate tax by estates that are illiquid because a substantial amount of their value is comprised of the business interest. Because liquidity problems may arise whether a closely held business interest is owned directly or indirectly through a holding company, Congress believed it was appropriate to permit certain holding companies to be "looked through" to determine whether an individual owned a qualifying interest in a closely held business. Congress believed that this look-through rule should be limited, however, to cases where the indirectly owned interest in an active business would qualify for the installment payment provision were it directly owned by the decedent.

Congress was concerned that allowing estate tax attributable to indirectly owned business interests to qualify for installment payments could result in an expansion of that benefit to interests in businesses other than those active, primarily family-operated, enterprises for which the benefit was originally enacted, or to ownership interests created primarily to reduce estate tax through the use of sophisticated planning techniques. To limit such an unwarranted expansion, Congress determined that the special restrictions that apply to cases where stock owned by family members is attributed to a decedent (i.e., the five-year deferral of principal and special four-percent interest rate) should apply in the case of active business interests owned indirectly through holding companies.

Congress further determined that similar rules should be applied in valuing a decedent's closely held business interest whether the business is operated as a proprietorship, a partnership, or a corporation. The Act provides, therefore, that investment assets owned by partnerships and corporations are disregarded when determining whether the business interest qualifies under the installment payment provision. This is the same rule that previously applied to businesses operated as proprietorships.

Explanation of Provisions

Qualification of certain holding company stock for installment payments

In general

The Act permits an executor to elect to look through certain holding companies to determine whether an estate includes an interest in an active business eligible for estate tax installment payments. If this election is made, certain indirectly owned stock in a corporation carrying on an active business that could be considered under the estate tax installment payment provision were the stock owned directly may be treated as directly owned stock in the active business.

Indirectly owned stock need not, by itself, qualify the estate for the installment payment provision. Rather, the indirectly owned stock may be combined with other stock that the decedent owned directly to qualify the estate. Likewise, stock the ownership of which is attributed to the decedent because family members actually own it may be considered in conjunction with directly owned stock and stock owned indirectly through a holding company.

The Act permits multiple holding companies to be looked through in determining whether the decedent owned an interest in an active corporation. Similarly, interests in multiple subsidiary corporations may be aggregated to determine whether the estate is eligible for installment payments. For example, an indirectly owned interest in a single closely held corporation may be eligible for installment payments, in certain cases, if (1) the corporation has 15 or fewer shareholders or (2) the decedent is treated as owning 20 percent or more of the indirectly owned corporation's voting stock, and the value of the business interest exceeds 35 percent of the value of the decedent's adjusted gross estate. As under prior law, if a decedent owns interests in more than one closely held business, at least 20 percent of the value of each such business must be included in the decedent's estate if the business interests are to be aggregated for purposes of the installment payment provision (sec. 6166(c)).

For purposes of the 35-percent test (sec. 6166(a)(1)), the value of both voting and nonvoting stock in an indirectly owned active business corporation is considered, regardless of whether the stock in all higher-tier holding companies representing that stock also has voting rights. However, indirectly owned stock is considered for purposes of the 20-percent test (sec. 6166 (b)(1)(A)) only if it, and all stock in higher-tier corporations representing indirect ownership of that stock, is voting stock.

Holding company defined

The Act defines a holding company to include any corporation owning stock in another corporation. This definition includes corporations that are themselves engaged in active business operations if such corporations own stock in other businesses (e.g., subsidiaries). Under this definition, unless the special look-through election provided under the Act is made, all stock in another corporation owned by any corporation generally is treated as a passive asset under the installment payment provision. (For a more complete discussion of the treatment of passive investment assets, see below.)

Requirement of nonreadily tradable stock

The look-through election is limited to cases where the stock is nonreadily tradable. Additionally, the stock representing the decedent's interest in all corporations in the chain to be looked through must be nonreadily tradable. Nonreadily tradable stock is stock that, on the date of the decedent's death, had no market on a stock exchange or in an over-the-counter market.

Under this rule, for example, if any of the decedent's stock in any corporation in the chain of corporations to be looked through is publicly traded, the election is not available with respect to that stock. Rather, all indirectly owned stock in the chain of corporations at and below the level of the publicly traded stock is treated as a passive investment asset and is not treated as an active business asset for purposes of the installment payment provision. In the case of directly owned stock for which a market exists, the value of the directly owned business may be considered for purposes of the installment payment provision, but that stock may not be looked through to qualify other stock, whether or not readily tradable, owned by the first corporation. *See*, however, the discussion on the treatment of investment assets, below, for a special rule under which multiple commonly owned corporations may be treated as a single corporation.

Limitation on four-percent interest rate and five-year deferral of principal payments

If an executor elects to include the value of stock owned indirectly through a holding company under the installment payment provision, the special four-percent interest rate and the five-year deferral of principal payments are not available.

Acceleration of unpaid installments

Special rules apply under the acceleration provisions of section 6166(g) if the executor makes an election under this provision of the Act. First, any disposition of holding company stock or withdrawal of money or other property from the holding company (including any intermediate-tier holding company) generally is treated as a disposition of or withdrawal from the closely held business qualifying for installment payments. In addition, if the holding company disposes of any of its active business stock or withdraws money or other property from the active business corporation, the disposition or withdrawal is included in determining whether unpaid installments are accelerated. Congress intended that the Treasury Department will issue regulations to ensure that dispositions or withdrawals from any corporation are considered only once in determining whether payment of estate tax is accelerated.

The Act also provides that, under the rules providing for acceleration of unpaid installments, if an estate has undistributed net income in any year, dividends paid to any holding company by any corporation carrying on the active business generally are treated as if the dividends were paid to the decedent's estate to the extent of the decedent's ownership (direct or indirect) of the corporation receiving the dividend.

Investment assets disregarded under the installment payment provision

The Act provides that, in the case of an interest in any business (proprietorship, partnership or corporation), passive assets are disregarded in determining the value of the business for all purposes of the installment payment provision other than the acceleration rules of section 6166(g). A passive asset is defined generally as any asset that is not used in carrying on a trade or business.

Assets will be disregarded under this rule unless they form part of a business' working capital or constitute reasonable reserves for financing of a specifically identified project. For example, a reserve for expansion of a factory building that is expected to be completed within a reasonable time after the contributions to the reserve fund are made would be a reasonable reserve. Congress was aware that corporations may be engaged in more than one type of business, and did not intend to exclude as passive, all assets of a business other than those used in its principal line of operations.

As stated above, any stock owned by one corporation in another corporation generally is treated as a passive asset of the owner. Under a special rule, however, a group of two or more active business corporations may be treated as one corporation if two conditions are satisfied. First, 80 percent or more of the value of each of the corporations must be attributable to the value of assets used in an active business operation. Second, either (1) each corporation owning stock must own 20 percent or more of the voting stock of the other corporations to be combined with it, or (2) the corporations in which stock is owned must have 15 or fewer shareholders. The 20-percent and 15-shareholder tests are measured independently with regard to each corporation in the group. If the special rule applies, a holding company election is not required to qualify each indirectly owned corporation under the installment payment provision. Rather, the subsidiaries or other commonly owned corporations are treated as divisions of a single corporation.[12] Passive investments of the group of corporations are not treated as business assets under the general rule providing that result.[13]

Effective Date

This provision of the Act applies to estates of individuals dying after the date of enactment (July 18, 1984).

An exception to the requirements of the look-through election of this provision is provided under which multiple wholly owned subsidiaries and a passive holding company may be treated as one cor-

[12] Under this special rule, multiple subsidiary corporations also may be treated as a single subsidiary. However, look-through election (sec. 6166(b)(8)) would have to be made before the group of subsidiaries could be treated as an interest in an active business under the installment payment provision.

[13] Congress was aware that an executor may be uncertain whether an estate qualifies under this rule at the time the estate tax return is filed. Because the look-through election may have to be made before it is determined whether the estate qualifies, Congress anticipated that the Treasury Department will prescribe rules under which estates may preserve their rights to make look-through elections if they subsequently are determined not to qualify under this special rule.

poration. This exception applies only if the holding company had fifteen or fewer shareholders on June 22, 1984, and at all times prior to the owner's death, and if at least some of the subsidiaries are carrying on a trade or business. For purposes of this exception, a *de minimis* amount of stock owned by the directors of a corporation, which stock under State law is treated as owned by the corporation, also is treated as owned by the corporation for purposes of this rule. If an executor elects to qualify an estate under this exception, the executor is treated as having made the special look-through election.

Revenue Effect

This provision is estimated to reduce fiscal year budget receipts by less than $5 million in 1984, $13 million in 1985, $19 million in 1986, $24 million in 1987, $29 million in 1988, and $36 million in 1989.

2. Permanent Rules for Reforming Governing Instruments Creating Charitable Remainder Trusts and Other Charitable Interests (sec. 1022 of the Act and sec. 2055 of the Code)[14]

Prior Law

The Tax Reform Act of 1969 imposed new requirements for a charitable deduction to be allowed for income, gift, and estate tax purposes for the transfer of a split interest to charity (i.e., an interest that is part charitable and part noncharitable). In the case of a remainder interest in trust, the interest passing to charity generally must be in certain specified forms, referred to as a charitable remainder annuity trust, a charitable remainder unitrust, or a pooled income fund. In addition, a deduction is allowed for a transfer of a remainder interest in a farm or personal residence. In the case of an "income" interest passing to charity (i.e., a charitable lead trust), the "income" interest must be either a guaranteed annuity or a fixed percentage of the fair market value of the trust (determined at least annually).

Prior law allowed the governing instruments of charitable split-interest trusts that were executed before December 31, 1979, to be amended to conform to the new requirements of the 1969 Act if the amendment was completed, or judicial proceedings necessary to amend the governing instrument were begun, by December 31, 1981.

Reasons for Change

Congress first permitted reformation of charitable remainder trusts in 1974, and since that time, Congress had extended the period for reformations several times and extended the procedure to other types of split-interest charitable contributions. Even so, it had come to the attention of Congress that there are still many instruments providing for split-interest charitable contributions that do not meet the requirements for qualification under the rules of the Tax Reform Act of 1969. In many of these cases, disqualification results in reduced amounts passing to charity. In light of the repeated need to extend the period to reform such governing instruments and the fact that failure to meet the 1969 Act rules often resulted in reduced amounts passing to charity, Congress believed that a permanent rule permitting reformation of split-interest charitable contributions should be provided as long as there are adequate safeguards to avoid abuse.

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[14] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 441; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), p. 1516; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 808; S. Prt. 98-169, Vol. I (April 2, 1984), p. 731; and H. Rep. No. 98-861 (June 23, 1984), p. 1242 (Conference Report).

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Specifically, Congress was concerned that governing instruments of charitable split-interest trusts that evidenced no attempt to comply with the 1969 Act rules would be reformed only if the defects were found on examination by the Internal Revenue Service. Congress believed that, in order for a governing instrument of a charitable split-interest contribution to be reformable, either (1) the creator had to make a bona fide attempt to comply with the 1969 Act rules, or (2) the taxpayer must have initiated reformation proceedings before the Internal Revenue Service could reasonably be expected to begin an examination. Congress believed that these rules will permit the correction of major, obvious defects (such as where the "income" interest is not expressed as an annuity interest or a unitrust interest) as long as the taxpayer initiates reformation proceedings before examination, while allowing the correction of minor defects (such as defects in determining the correct payout in short taxable years or in years of additional contributions, etc.) upon examination as long as there was a good faith attempt to comply with the 1969 Act rules (i.e., the payout is expressed basically as an annuity interest or a unitrust interest).

Finally, Congress believed that any reformation proceedings necessary to cure defective governing instruments should not be an opportunity to revise significantly the substance of the split-interest transfer, especially where the change reduces the charity's share of the trust corpus. Accordingly, Congress provided that the relative actuarial values of the interests of the charitable beneficiaries before and after the reformation may not change by more than than five percent and that the durations of the interests before and after the reformation should be the same. In addition, to ensure that the reformation procedure is not used to increase the amount of any charitable contribution deduction allowed with respect to the original transfer, Congress provided that the deduction under the reformed governing instrument may not exceed the actuarial value of the charitable interest before the reformation.

Explanation of Provisions

In general

The Act provides a permanent rule permitting reformation of governing instruments of charitable split-interest trusts that do not meet the requirements of the rules enacted in 1969.

In general, reformations will be allowed where either the instrument evidences an intent to comply with the 1969 rules or the reformation proceedings are begun before there is an opportunity by the Internal Revenue Service to examine the matter. In addition, the Act requires that the actuarial values and durations of the charitable and noncharitable interests in the trust generally must remain the same before and after the reformation. This is achieved by allowing an income, gift, or estate tax charitable deduction for property passing to charity in respect of any *qualified reformation* of a *reformable interest* into a *qualified interest.*

Qualified reformation

A qualified reformation is a change in the governing instrument of a trust that amends a reformable interest into a qualified interest. As under prior law, the reformation must be retroactive to the date of death in the case of testamentary trusts or the date of creation in the case of *inter vivos* trusts and must provide for correction of any overpayments or underpayments prior to reformation. To ensure proper taxation of the trust and its beneficiaries, the Act provides that the period for assessing any deficiency does not expire before the date that is one year after the Secretary of the Treasury is notified that the reformation has occurred.

Two general requirements must be satisfied for a reformation to be qualified. First, the difference between the actuarial value of the charitable interests of the reformed trust and the unreformed trust may not exceed five percent of the actuarial value of the charitable interest before the reformation.[15] The second requirement limits changes in the length of the charitable and noncharitable interests in the trust. In the case of a charitable remainder trust, the noncharitable interests must terminate at the same time before and after the reformation.[16] An exception is provided to this rule permitting a noncharitable interest that is for a term of years in excess of 20 years to be reduced to 20 years.[17] In the case of other interests (e.g., charitable lead trusts), the charitable interest must be of the same duration under both the reformed and unreformed trusts.

Reformable interest

An interest must satisfy two conditions to qualify as a reformable interest. First, the charitable interest prior to the reformation must have been in a form for which a deduction would have been allowable for that interest under the rules applicable to split-interest transfers prior to enactment of the Tax Reform Act of 1969.

Second, either (1) the reformation must be commenced [18] within a specified period or, (2) in the case of wills executed after December 31, 1978, the will creating the trust must evidence an intent to comply with the 1969 Act. Generally, the first alternative requires that proceedings be commenced within 90 days after the due date (including extensions) of the estate tax return on which a charitable deduction for the transfer to the trust is claimed. If no estate tax return is required to be filed for such a transfer, the period terminates 90 days after the due date (with extensions) for the first required income tax return for the trust. Congress intended that, for the commencement of a judicial proceeding to be timely, the pleading must describe the nature of the defect that must be cured. The filing of a general protective pleading is not sufficient.

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[15] Under the Act, a reformation that changes the relative interests of noncharitable beneficiaries may be a qualified reformation. However, such changes may be gifts from one noncharitable beneficiary to another noncharitable beneficiary.

[16] Where an unreformed trust contains a contingency that accelerates the charitable remainder interest, the actuarial value of the charitable and noncharitable interests before the reformation is to be determined, for this purpose, without regard to the contingency.

[17] In such a case, the amount of the annual noncharitable distributions must be increased to ensure that the actuarial value of the charitable and noncharitable interests are the same before and after the reformation.

[18] Where a judicial proceeding is begun in one court, but it is later determined that the proceeding should have been commenced in a different court (for example, where it is determined that jurisdiction over the trust lies in a different State), the proceeding will be treated as timely filed if the first proceeding was timely filed.

A governing instrument is considered to evidence an intent to comply with the 1969 Act rules if all current payouts from the trust are expressed solely as a fixed dollar amount or a fixed percentage of the value of the trust's assets. Thus, a trust does not meet this requirement if the governing instrument provides any powers of invasion for a noncharitable beneficiary. However, failure to have detailed rules relating to the computation of the fixed dollar amount or the fixed percentage of the value of the trust's assets in special circumstances (e.g., short taxable years, years where there are additional contributions, or the year when interests terminate, etc.) will not preclude the interest from being a reformable interest. In addition, an interest is considered to be expressed as a fixed percentage of the value of the trust's assets if the current payout is expressed as the lesser of trust income or a fixed percentage of the value of the trust's assets or the current payout is expressed in any other formulation that indicates an intent to create a trust described in section 664(d)(3).

Method of reformation

The Act provides that a qualified reformation may be achieved by any method permitted under applicable local law as long as that change is binding on all relevant parties. Thus, changes may be accomplished by reformation, amendment, construction, or otherwise, as long as those changes are binding on all parties under local law.

In addition, the Act provides that the death of all of the noncharitable "income" beneficiaries of a charitable remainder trust before the timely filing of the estate tax return on which the charitable deduction for the transfer to the trust is claimed is treated as a qualified reformation. In such a case, the charitable deduction is the actuarial value of the remainder interest before the reformation, adjusted for any payments made before the death or deaths to "income" beneficiaries.

The Act also provides that a reformation occurs where, pursuant to the governing instrument of a trust, all or a specific portion of the trust passes directly to charity before the due date of the estate tax return (including extensions).

Amount of allowable deduction

If a qualified reformation occurs, a deduction is allowed for an amount equal to the lesser of (1) the actuarial value of the charitable interest after the reformation, or (2) the actuarial value of the charitable interest before the reformation for which a deduction would have been allowable but for the disallowance rules of the Code (sec. 2055(e)(2)).[19]

Effect of reformation for other purposes

The Act directs the Treasury Department to prescribe regulations concerning the taxation of trusts and the application of the rules relating to exempt organizations and private foundations to trusts that are reformed pursuant to the provisions of the Act. Con-

[19] In determining the actuarial value of the charitable interest of the unreformed trust, Congress intended that trusts to which Rev. Proc. 73-9, 1973-1 C.B. 758, applies, be treated as if they had complied with that revenue procedure.

gress intended that those regulations continue the prior-law rule that, in the case of a reformation of a charitable remainder trust, the exemption from tax and the income characterization of payments provided by section 664 are retroactive to the creation of the trust.

Pooled income funds, farms, and personal residences

The Act also directs the Treasury Department to prescribe rules permitting the reformation of charitable transfers involving remainder interests in pooled income funds, farms, and personal residences. The rules are to be consistent with the rules provided by the Act for reformations of charitable remainder annuity trusts and charitable remainder unitrusts.

Special rule for contingencies in charitable remainder trusts

The Act includes a special exception to the rule that the noncharitable interests in a charitable remainder annuity trust or a charitable remainder unitrust must terminate at the end of lives in being or a term of years (not to exceed 20 years). Under the special exception, contingencies in the time that annuity trust or unitrust interest payments are to be made are permitted where a trust provides that such interests terminate at times permitted by prior (and present) law, and provides additionally that those interests may terminate at some earlier time such that the charitable remainder interest is accelerated. For example, the annuity trust interest or unitrust interest may terminate at the earlier of death or remarriage of a named individual. In such a case, the value of the charitable remainder is determined without regard to the contingency (i.e., the value of the charitable remainder is determined as if the payments of the annuity trust interest or unitrust interest did not terminate until the periods permitted by prior law). For example, where the annuity trust interest or unitrust interest lasts until the earlier of the death or remarriage of a named individual, the value of the remainder interest is determined as if the annuity trust interest or unitrust interest terminated at the death of the named individual.

Effective Date

These provisions apply to reformations made after December 31, 1978, other than reformations to which prior law (as in effect before enactment of the Act) applies.

The Act also provides a special rule that opens the period of limitations for assessment of tax until July 18, 1985. Thus, in the case of a reformation in 1979 of a trust created pursuant to a will executed in 1979, the period of limitations for the estate tax deduction with respect to transfers to the trust or with respect to the income taxation of the trust will not expire earlier than July 18, 1985. However, where a credit or refund is made that is allowed by reason of the extension of the period of limitations, no interest is allowable on such claim or refund for the period before 180 days after the Treasury is notified of the reformation.

Revenue Effect

These provisions are estimated to decrease revenues by less than $5 million annually.

3. Alternate Valuation Date Election (secs. 1023 and 1024 of the Act and sec. 2032 of the Code) [20]

Prior Law

The value of property included in an individual's gross estate for Federal estate tax purposes generally is determined on the date of the individual's death. However, the executor of the individual's estate may elect to have the value of all property included in the gross estate determined as of the alternate valuation date, which generally is the date six months after the date of the individual's death (Code sec. 2032). Under prior law, the election to use the alternate valuation date could be made only on a timely filed Federal estate tax return. The election could be made whether or not the Federal estate tax liability of the estate was reduced.

The basis of property acquired from a decedent in the hands of the decedent's estate or his or her heirs generally is the value of that property determined for Federal estate tax purposes (i.e., the basis is "stepped up" or "stepped down" to fair market value at death or alternate valuation date).

Reasons for Change

Congress' original purpose in providing an election to use an alternative valuation date for estate tax purposes was to provide relief so that estate taxes are not inordinate in cases where the value of the property in an estate decreases after death. However, Congress believed changes in the law since that time have led to abuse of this relief provision.

Where property appreciates in value after the date of an individual's death, it was possible under prior law to elect the alternate valuation date to increase the income tax basis of the property even though no additional Federal estate tax resulted from the election. Additionally, this election could be made without resulting in imposition of estate tax either because the value of the estate did not exceed the exemption equivalent of the unified credit or because the appreciated property was transferred to the decedent's surviving spouse and a marital deduction claimed.

Because the purpose of the the alternate valuation date provision was to provide estate tax relief and not to be a general method of avoiding income taxes, Congress believed that the election to use the alternate valuation date should be restricted to cases where there are estate tax consequences.

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[20] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, secs. 442 and 443; H Rep. No. 98-432, Pt. 2 (March 5, 1984), p. 1521; Senate floor amendment, 130 Cong. Rec. S 4521 (April 12, 1984); and H. Rep. No. 98-861 (June 23, 1984), p. 1243 (Conference Report).

In addition, Congress believed that there was no reason for requiring that the election be made on a timely filed estate tax return as long as the Internal Revenue Service is given an adequate opportunity to determine correct tax liabilities after the election is made. To deny this benefit solely because a return is filed late is in substance the creation of a new penalty, in addition to the penalty provisions designated as such in the Code.

Explanation of Provisions

The Act provides that the election to use the alternate valuation date may be made only where both the total value of all property in the gross estate and the Federal estate tax liability of the estate are reduced.

The Act also provides that the alternate valuation date election may be made on the first estate tax return filed (whether filed timely or late). Once an election is made, however, it is irrevocable.

Effective Date

These provisions are effective generally with respect to individuals dying after the date of enactment (July 18, 1984).

A special rule permits estates that would qualify for the alternate valuation date provision, as amended, except for the fact that the estate tax return was filed previously, to make the election within 90 days after enactment. This special rule is limited to estates for which the period of limitations for assessment of tax had not expired on the date of enactment. Additionally, in such cases, the period for assessing any deficiency does not expire before the date that is one year after the date the election is made.

Revenue Effect

The provision limiting the alternate valuation date election to estates where it results in a reduction in the value of the gross estate and in estate tax is estimated to increase budget receipts by $10 million annually. The provision relating to time for filing the election is estimated to reduce budget receipts by less than $1 million annually.

4. Perfection of Estate Tax Current Use Valuation Elections (sec. 1025 of the Act and sec. 2032A of the Code) [21]

Prior Law

An executor may elect to value certain real property used in farming or other closely held business operations for estate tax purposes based upon its current use value rather than its full fair market value (Code sec. 2032A). The election may be made only on the first estate tax return filed and is irrevocable once made. Additionally, all persons with an interest in the property to be specially valued must enter into an agreement to the election. The agreement must be binding under local law.

Treasury Department regulations require that a notice of election and the required agreement must be filed with the estate's Federal estate tax return (Treas. Reg. sec. 20.2032A-8). Under prior law, the administrative policy of the Treasury Department was to disallow current use valuation elections unless the notice of election and agreement as originally filed complied in all respects with the regulations.

Reasons for Change

Congress was concerned that the prior Treasury Department administrative policy unnecessarily penalized executors making current use valuation elections for mistakes that were reasonable in light of the circumstances existing at the time the elections were made. Congress believed, therefore, that executors should be allowed to perfect such mistakes upon notification by the Internal Revenue Service.

Congress was aware, however, that unless some level of compliance with Treasury regulations were required, some persons might intentionally neglect to comply unless they were discovered on examination. The Act requires that both a notice of election and an agreement to the current use valuation election that substantially comply with the requirements of Treasury regulations accompany the estate tax return, as originally filed. Congress believed that requiring these documents to be filed with the estate tax return and requiring their substantial compliance will prevent this potential abuse.

Explanation of Provisions

The Act directs the Treasury Department to develop procedures permitting perfection of notices of election and agreements to current use valuation elections within 90 days of a request from the

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[21] For legislative background of the provision, see: Senate floor amendment, 130 Cong. Rec. S. 4318 (April 11, 1984); and H. Rep. No. 98-861 (June 23, 1984), p. 1240 (Conference Report).

Internal Revenue Service.[22] Under the Act, perfection of notices of election and of agreements to current use valuation elections is to be permitted only in cases where the estate tax return, as filed, evidences substantial compliance with the requirements of the Treasury regulations. For example, merely checking the applicable box on the Federal estate tax return that an election is being made is not sufficient action by the estate to secure the benefits of the current use valuation provision. Both a notice of election and an agreement that themselves evidence substantial compliance with the requirements of the regulations must be included with the estate tax return, as filed, if the estate is to be permitted to perfect its election.

The determination of whether a return, as filed, substantially complies with the requirements of the Treasury regulations is factual, and must be made on a case-by-case basis. An important factor to consider is whether the error or omission was reasonable under the circumstances present when the estate tax return was filed originally. The type of information that may be supplied after the initial filing of a notice of election includes (but is not limited to) omitted social security numbers and addresses of qualified heirs and copies of written appraisals of the property to be specially valued. This provision does not, however, permit such appraisals to be obtained after the estate tax return is filed. Rather, the provision only permits the submission of previously obtained appraisals. Likewise, a notice of election that does not provide a legal description of the property to be specially valued may not be perfected unless the notice, as initially filed with the estate tax return, described the property with reasonable clarity, even though the full legal description was not provided.

As stated above, an agreement to the current use valuation election may be perfected under this provision provided the agreement, as filed with the estate tax return, evidences substantial compliance with the requirements of the regulations. To be eligible for perfection, the agreement as filed originally must at a minimum be valid under State law and must include the signatures of all parties having a present interest or a remainder interest (other than a present interest or a remainder interest having a relatively small value).[23]

The right to perfect agreements was intended to be available in cases where, for example, the existence of an heir was unknown at the time the estate tax return was filed, or where a parent of a minor remainderman, rather than a guardian ad litem as required under State law, signs the agreement on behlaf of the minor heir. Perfection also is to be permitted if, for example, a tenant-in-

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[22] Congress was aware that this 90-day period for certain estates may have commenced before enactment of the provision. It was anticipated that the applicable 90-day period in such cases would not expire before 90 days after the date of enactment.

[23] Congress was aware that Treasury regulations under the current use valuation provision require that, when successive interests are created in specially valued property, all parties with any interest in the property must be qualified heirs and all such parties must enter into the agreement to the election, regardless of the relative values of their interests. The *de minimis* rule established in this provision was intended to apply solely as a guideline in determining whether perfection of an agreement is to be permitted. This rule was not intended to give rise to an inference that parties having an interest in specially valued property that has a relatively small value are not required to enter into the agreement, or that such persons need not be qualified heirs.

common with the decedent (which co-tenant does not inherit the decedent's interest in the specially valued property) originally does not sign the agreement. Similarly, failure to designate an agent in the agreement as filed may be corrected under this provision.

Effective Date

This provision applies to estates of individuals dying after 1976. A special rule extends the period of limitations for assessment of tax until July 18, 1985, to permit perfection of current use valuation elections where such actions otherwise would be barred.

Revenue Effect

This provision will have a negligible effect on budget receipts.

5. No Gain Recognized from Net Gifts Made Before March 31, 1981 (sec. 1026 of the Act) [24]

Prior Law

For Federal income tax purposes, gross income means "all income from whatever source derived" (Code sec. 61). Income may be realized from a variety of indirect means as well as from direct transfers. For example, the benefit resulting from the discharge of one's indebtedness by another party constitutes gross income (sec. 61(a)(12)); *Old Colony Tr. Co.* v. *Commissioner*, 279 U.S. 716 (1929); *Crane* v. *Commissioner*, 331 U.S. 1 (1947)).

A gift tax is imposed on certain transfers for less than adequate consideration (sec. 2501). Responsibility for payment of the gift tax is on the donor of the transferred property (sec. 2502), and the gift tax is determined by reference to the value of the property transferred by the donor.

In most cases, the value of the transferred property does not include the amount of gift tax paid by the donor. However, a donor may transfer property pursuant to an agreement with the donee that the donee will pay any gift tax arising from the transfer. In such cases, the amount of the gift is less than the full value of the transferred property, and the donee discharges a debt of the donor with the balance of the transferred value (i.e., a "net gift" is made).

On June 15, 1982, the U.S. Supreme Court ruled in *Diedrich* v. *Commissioner* [25] that payment of gift tax by a donee results in gain to the donor to the extent that the gift taxes exceed the donor's adjusted basis in the transferred property.

Reasons for Change

Prior to the *Diedrich* decision, several courts had ruled that the transfer of property subject to the transferee paying any gift tax did not result in any gain realized by the transferor.[26] While Congress believed that the *Diedrich* decision is correct, it also believed that taxpayers should not be affected adversely because they may have made such transfers in reliance upon what was thought to be established law that no income tax liabilities would accrue from such transfers.

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[24] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 802; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), p. 1707; and H. Rep. No. 98-861 (June 23, 1984), p. 1241 (Conference Report).

[25] 457 U.S. 191 (1982).

[26] See, for example, *Turner* v. *Commissioner*, 410 F.2d 752 (6th Cir. 1969).

Explanation of Provision

The Act provides that the payment of (or the agreement to pay) gift tax by a donee with respect to gifts made before March 4, 1981,[27] does not result in income to the donor whose gift tax liability was thereby discharged. The provisions of the Act apply to both the Federal gift tax and to any gift tax imposed on such transfers by a State. However, the Act does not apply unless the gift tax actually was paid by the donee.

Effective Date

This provision is effective on the date of enactment (July 18, 1984). A special rule also extends the period of limitations for assessment of tax to permit the filing of a claim for refund until July 18, 1985, where that period would otherwise have expired before that date.

Revenue Effect

This provision is estimated to reduce budget receipts by less than $5 million annually.

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[27] March 4, 1981, was the date on which the U.S. Court of Appeals for the Eighth Circuit held that the donor in the *Diedrich* case was required to recognize income from the disputed transfers.

6. Clarification that Certain Usufruct Interests Qualify for Estate Tax Marital Deduction (sec. 1027 of the Act and secs. 2053 and 2056 of the Code) [28]

Prior Law

An unlimited estate tax deduction is permitted for the value of interests in property passing from an individual to his or her surviving spouse (Code sec. 2056). In general, the deduction is available only if the property interest is not a "terminable interest." A terminable interest is an interest (e.g., a life estate) that terminates upon the lapse of time or the occurrence or failure to occur of an event or other contingency.

Executors of estates may elect to claim a deduction for certain qualified terminable interest property ("QTIP" property) passing to an individual's surviving spouse. If this election is made, the full value of the QTIP property is includible in the estate of the surviving spouse, or is treated as a gift by the surviving spouse if the spouse makes an inter vivos transfer of any part of his or her interest in the property (secs. 2044 and 2519). The estate of the second spouse to die generally is entitled to recover from the remaindermen the amount of gift or estate tax arising from the transfer of the QTIP property (sec. 2207A).

QTIP property is property passing from the decedent with respect to which the surviving spouse has a right to all income, payable annually or at more frequent intervals. Additionally, no person may have a power to appoint any part of the property to any person other than the surviving spouse unless the power is exercisable only at or after the death of the surviving spouse.

Under the Louisiana Civil Code, the equivalent real property interest to a common-law life estate is a usufruct for life. A usufruct may be in consumable or nonconsumable property. If the usufruct is in consumable property, Louisiana law does not trace the usufruct property to find if that property actually is included in the surviving spouse's estate.

A deduction generally is allowed in determining estate tax for certain debts and costs of administration paid by the estate (sec. 2053).

Reasons for Change

Congress believed that it was unclear under prior law whether a QTIP election was available with respect to all usufruct interests for life under the Louisiana Civil Code. Congress determined that this ambiguity should be resolved to ensure that estates of Louisi-

[28] For legislative background of the provision see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 1027; S. Prt. 98-169, Vol. I (April 2, 1984), p. 721; and H. Rep. No. 98-861 (June 23, 1984), p. 1238 (Conference Report).

ana decedents receive benefits of the estate tax marital deduction that are comparable to the benefits received by estates of residents of the common-law States.

Explanation of Provisions

The Act redefines the term "qualified income interest for life" to include interests under which (1) the surviving spouse is entitled to all of the income from the property, payable annually or at more frequent intervals, or has a usufruct interest for life in the property, and (2) no person has a power to appoint any part of the property to any person other than the surviving spouse (except for a power exercisable only at or after the spouse's death).

The Act further provides that the QTIP election is to be available without regard to whether a usufruct interest is in consumable or nonconsumable property. Congress recognized that different results arguably might obtain in cases where a usufruct for life with respect to which a QTIP election is made is in consumable property (e.g., a certificate of deposit) as opposed to nonconsumable property (e.g., land). This difference could result from the fact that, unlike nonconsumable property, the consumable property is commingled with the spouse's own property and Louisiana law does not provide for tracing of the consumable property in the estate.

In the case of nonconsumable property, because the specific QTIP property can be identified, the entire value of that property is to be included in the estate of the second spouse to die exclusively under Code section 2044. Therefore, the value of the property is counted only one time in determining the value of the spouse's estate. Under this rule, the claim of that spouse's estate for estate tax attributable to QTIP property is based upon the value of the actual QTIP property (as is true in a common-law State). Similarly, no deduction is allowed under section 2053 for any claim against a surviving spouse's estate by the remainderman ("naked owner" under Louisiana law) of the nonconsumable usufruct property for which a QTIP election was made by the estate of the first spouse to die.

Congress intended that these same results obtain in the case of a usufruct for life in consumable property with respect to which a QTIP election is made. A usufruct for life in consumable property for which a QTIP election is made is to be treated as exclusively included in the estate of the second spouse to die under section 2044 to the extent of the naked owner's claim against the spouse's estate with respect to the property, and as exclusively included under section 2033 to the extent of any excess value. Similarly, the claim of that spouse's estate for recovery of estate tax from the naked owners of the property is to be limited to an amount of tax determined as if the value of the usufruct interest included in the spouse's estate were equal to the amount included in the estate under section 2044.

Finally, no deduction is allowed under section 2053 for any claim against the surviving spouse's estate by the naked owners of the usufruct property with respect to which a QTIP election was made by the estate of the first spouse to die.

Effective Date

This provision applies as if included in section 403 of the Economic Recovery Tax Act of 1981 (P.L. 97-34).

Revenue Effect

This provision is estimated to reduce fiscal year budget receipts by less than $5 million annually.

7. Special Estate Tax Credits (sec. 1028 of the Act) [29]

Prior Law

A deduction generally is allowed for estate tax purposes for certain amounts transferred for charitable purposes (Code sec. 2055). The United States is a qualified donee of such deductible transfers. Credits against estate tax are not provided for transfers for charitable purposes.

If an estate has an estate tax liability after taking into account all allowable deductions and credits, that liability generally must be paid in cash or a cash equivalent (i.e., check or money order) (sec. 6311). Certain series of Treasury bonds (often called "flower bonds") also may be used to pay estate tax. To be eligible, these bonds must have been issued as part of certain pre-March 4, 1971, series of bonds, have been owned by the decedent at the time of his or her death, and have been included in the decedent's gross estate (sec. 6312).

Except in a case where the Internal Revenue Service must levy to secure payment of tax, real property and personal property other than cash or flower bonds may not be used to pay estate tax.

Reasons for Change

Congress believed that the Secretary of the Treasury should be authorized to accept payment of estate tax in kind in the cases of the Estate of Nell J. Redfield and the Estate of Elizabeth Schultz Rabe. In this way, a forced sale of certain land within or adjacent to the Toiyabe National Forest could be avoided, and the property could be transferred to the Secretary of Agriculture for administration by the National Forest Service.

Explanation of Provisions

Estate of Nell J. Redfield

The Act provides a special credit against Federal estate tax imposed on the Estate of Nell J. Redfield. The credit applies to the transfer, without reimbursement or payment, to the Secretary of Agriculture for addition to the Toiyabe National Forest of real property located within or adjacent to the boundaries of that national forest. The credit is available only if the transfer occurred before October 19, 1984.

The amount of the credit is equal to the lesser of (1) the fair market value of the transferred property as determined for Federal

[29] For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 1028; S Prt. 98-169, Vol I (April 2, 1984), p. 723; and H. Rep. No. 98-861 (June 23, 1984), p. 1240 (Conference Report).

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estate tax purposes, or (2) the estate's Federal estate tax liability (plus interest thereon).

Estate of Elizabeth Schultz Rabe

The Act also provides a special credit against Federal estate tax imposed on the Estate of Elizabeth Schultz Rabe. The credit applies to the transfer, without reimbursement or payment, of approximately 97.6 acres of property located in Douglas County, Nevada, to the Secretary of Agriculture for addition to the Toiyabe National Forest. The credit is available only if the transfer occurred before October 19, 1984.

The amount of the credit is equal to the lesser of (1) the fair market value of the transferred property as determined for Federal estate tax purposes, or (2) the estate's Federal estate tax liability (plus interest thereon).

Effective Date

These provisions became effective on the date of enactment (July 18, 1984).

Revenue Effect

These provisions are estimated to result in a one-time revenue loss of $22 million in fiscal year 1984.

D. Charitable Contributions and Exempt Organizations

1. Charitable Expense Deduction for Use of Passenger Automobile (sec. 1031 of the Act and sec. 170 of the Code) [30]

Prior Law

Unreimbursed out-of-pocket expenses incurred by a taxpayer in rendering services to an organization contributions to which are deductible under section 170 are eligible for deduction as charitable contributions (Treas. Reg. sec. 1.170A-1(g)).

In determining the amount treated as a charitable contribution where a taxpayer operates a vehicle in providing services to a charity, the taxpayer either may deduct actual out-of-pocket expenditures or may use a standard mileage rate. Under prior law, the mileage rate was set by the Internal Revenue Service at nine cents a mile (Rev. Proc. 82-61, 1982-2 C.B. 849). The taxpayer may also deduct (under either computation method), any parking fees and tolls incurred in rendering the services, but may not deduct any amount (regardless of the computation method used) for general repair or maintenance expenses, depreciation, insurance, registration fees, etc.

Reasons for Change

The Congress recognized that in recent years, greater numbers of individuals have volunteered their services to help carry out the exempt-purpose activities of charitable organizations, such as scouting and other youth activities, providing meals to the homeless or elderly, etc. In many instances, these volunteers incur actual out-of-pocket expenses in rendering services to charities, such as where an individual uses his or her own car in delivering meals to the homeless or elderly on behalf of a charity, and is not reimbursed for use of the car for this purpose. To support the efforts of these volunteers, who do not receive any charitable deduction for the value of their contributed services, the Congress believed that the standard mileage rate allowed for computation of the charitable deduction for use of a passenger automobile in providing services to a charity should be increased to 12 cents a mile in order to take into account additional out-of-pocket costs of operation.

Explanation of Provision

Under the Act, the standard mileage rate which may be used in determining the amount of a taxpayer's charitable contribution deduction for the use of a passenger automobile in performing ser-

[30] For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 808; S. Prt. 98-169, Vol. I (April 2, 1984), p. 730; and H. Rep. No. 98-861 (June 23, 1984), p. 1084 (Conference Report).

vices for a charity, if the actual expense method is not used, is increased to 12 cents a mile. (As with the prior-law mileage rate, the taxpayer may also deduct any parking fees and tolls incurred in rendering the services, but may not deduct any amount for general repair or maintenance expenses, depreciation, insurance, registration fees, etc.). The deduction for such use of a passenger automobile is allowable, as in the case of other types of charitable contributions, only if verified pursuant to Treasury regulations (sec. 170(a)(1)).

Since under the Act the standard mileage rate is set by statute, the Internal Revenue Service does not have authority to change, by administrative action, the mileage rate for purposes of computing the charitable deduction allowed for use of a passenger automobile in performing services for a charitable organization.

Effective Date

The provision is effective for taxable years beginning after 1984.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by $5 million in 1985, $37 million in 1986, $43 million in 1987, $51 million in 1988, and $60 million in 1989.

2. Tax Treatment of Certain Nonprofit Child Care Organizations (sec. 1032 of the Act and secs. 170, 2055, and 2522 of the Code)[31]

Prior Law

Nonprofit organizations which are organized and operated exclusively for religious, charitable, educational, or other specified purposes, and which meet certain other requirements, are exempt from Federal income tax (sec. 501(c)(3)). Contributions to such organizations are deductible for Federal income, gift, and estate tax purposes (secs. 170, 2055, and 2522).

Under prior law, the Internal Revenue Service had ruled that nonprofit day care centers may be eligible for tax exemption and tax-deductible contributions where enrollment is based on financial need of the family and the need of the child for the program,[32] or where the center provides pre-school age children of working parents with an educational program through a professional staff of qualified teachers.[33] Under the facts involved in these rulings, the Internal Revenue Service had concluded that any private benefits derived by the parents of enrolled children or the employer of the parents were merely incidental to the public benefits resulting from the center's operation, and hence were not inconsistent with tax exemption. Similarly, the Tax Court had upheld the tax-exempt status of child care centers in circumstances where the custodial services of the center were incidental to its educational activities,[34] but not where the center's operations do not serve the community as a whole.[35]

Reasons for Change

The Congress was informed that definitional difficulties had arisen with respect to whether certain nonprofit day care organizations which provided after-school care to children or care for infants or toddlers met the prior-law requirements for tax-exempt status and eligibility for tax-deductible contributions as educational or charitable organizations. Accordingly, the Congress believed that certain nonprofit day care organizations which make their services available to the general public should be considered to have educational purposes without regard to prior-law interpretation of that term as applied to such day care organizations. The Congress did not intend this modification of prior law to affect the meaning of

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[31] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 816; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1756-57; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 881; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 897-98; and H. Rep. No. 98-861 (June 23, 1984), p. 1100 (Conference Report).

[32] Rev. Rul. 68-166, 1968-1 C.B. 255.

[33] Rev. Rul. 70-533, 1970-2 C.B. 112.

[34] *San Francisco Infant School, Inc.* v. *Comm'r*, 69 T.C. 957 (1978), acq. 1978-2 C.B. 2.

[35] *Balt. Regional Joint Board Health and Welfare Fund* v. *Comm'r*, 69 T.C. 554 (1978).

the terms "educational" or "charitable" for any purpose other than that of treating the child care organizations described in the provision as having educational purposes.

Explanation of Provision

The Act provides that the term "educational purposes," as used for purposes of tax-exempt status under section 501(c)(3) and eligibility for tax-deductible contributions under sections 170, 2055, and 2522, includes the providing of care of children (away from their homes) if both (1) substantially all of the child care provided by the organization is for the purpose of enabling individuals to be gainfully employed, and (2) the services provided by the organization are available to the general public. This provision is not intended to affect the meaning of the terms "educational" or "charitable" for any purpose other than considering the child care organizations described in the provision as having educational purposes.

Effective Date

The provision is effective for taxable years beginning after the date of enactment (July 18, 1984).

Revenue Effect

The provision is estimated to reduce budget receipts by less than $5 million annually.

3. Church Tax Inquiries and Examinations (sec. 1033 of the Act and secs. 6501, 7428, and 7605(c) and new sec. 7611 of the Code)[36]

Prior Law

Internal Revenue Service authority to examine taxpayers' records

IRS summons authority

The Internal Revenue Service is authorized to examine taxpayer records for the purpose of assessing or collecting tax. In addition, the IRS may summon any individual to appear before a revenue agent to give testimony under oath or to produce books and records (Code sec. 7602).

The United States Supreme Court has held that, for a summons to be enforceable in a civil tax proceeding, the IRS must demonstrate (1) that the investigation will be conducted pursuant to a legitimate purpose, (2) that the material sought is relevant to that purpose, (3) that the information is not already in the possession of the IRS, and (4) that the proper administrative procedures have been followed (*Powell* v. *Commissioner*, 379 U.S. 48 (1964)).

Conduct of examinations

The IRS must conduct examinations of taxpayers and their records in a reasonable manner. The IRS is prohibited specifically from inspecting a taxpayer's records twice for the same tax year without notifying the taxpayer in writing that such additional inspection is necessary (sec. 7605(b)).

Examination of churches

Churches, like other organizations organized and operated exclusively for religious, charitable, or educational purposes, are exempt from Federal income tax (sec. 501(c)(3)). Exempt organizations, including churches, are subject, however, to tax on income from the conduct of any trade or business that is not related substantially to the organization's exempt purpose (secs. 511-14).

The Tax Reform Act of 1969 (P.L. 91-172) imposed special restrictions on IRS examination of churches for the purpose of determining whether a church was engaged in activities that resulted in unrelated business taxable income (sec. 7605(c)). These restrictions were applied generally at the administrative level to investigations of church tax-exempt status. These restrictions included special rules concerning the extent of any examination of church books of account and the notice required to be given in advance of such ex-

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[36] For legislative background of the provision see. "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 872; S. Prt. 98-169, Vol I (April 2, 1984), p. 870; and H. Rep. No 98-861 (June 23, 1984), p. 1101 (Conference Report).

amination. Prior law also provided additional restrictions on the examination of church religious activities.

Examination of church books of account

Notice requirement

Under prior law, the IRS was prohibited from examining the books of account of a church (including conventions or associations of churches) unless (1) an IRS regional commissioner believed that such examination was necessary, and (2) the regional commissioner so notified the organization in advance of the examination. The IRS interpreted "books of account" to include accounting and bookkeeping records (e.g., cash books, ledgers, etc.) kept in the regular course of business to provide detailed financial records (Internal Revenue Manual 7(10)71.22(1)). Third party records (e.g., cancelled checks held by a bank) were not considered to be books of account. However, access to such materials by the IRS was subject to the general provisions of the Code regarding third party summonses (sec. 7609).

Prior Treasury Department regulations required that notification to a church be made in writing at least 30 days before examining church books of account. The regulations provided further that a regional commissioner could conclude that an examination was necessary only after reasonable attempts had been made to obtain information by written request and the regional commissioner had determined that the information could not be obtained fully or satisfactorily in that manner. Treas. Reg. sec. 301.7605-1(c)(2).

Scope of examination

Prior law provided that the books of account of an organization that claimed to be a church could be examined only to the extent necessary to determine the amount (if any) of tax due. Under Treasury Department regulations, this rule was applied to examinations (1) to determine the initial or continuing qualification of the organization as a tax-exempt entity under section 501(c)(3); (2) to determine whether the organization was qualified to receive tax-deductible contributions; (3) to obtain information for the purpose of determining the tax liability of a recipient of payments (e.g., minister's salaries) from the organization; or (4) to determine the amount of tax, if any, which was to be imposed on the organization. The regulations provided further that, in any examination of a church for the purpose of determining liability for tax on unrelated business income, church books of account could be examined only to the extent "necessary" to determine such liability. Treas. Reg. sec. 301.7605-1(c)(2).

In *United States* v. *Dykema*, 666 F.2d 1096 (7th Cir. 1981), *cert. den.* 496 U.S. 983 (1982), the United States Court of Appeals for the Seventh Circuit held that the limitation to "necessary" examinations of churches applied only to investigations of unrelated business income. The case involved an IRS summons for various church books of account as part of an investigation of the church's tax-exempt status. The court held that the IRS could examine any church records relevant and material to a determination of tax-exempt status.

Examinations of religious activities

Prior law provided that, when an organization claimed to be a church, the religious activities of the organization could be examined only to the extent necessary to determine whether the organization actually was a church. Treasury Department regulations provided that this restriction applied to examinations (1) to determine the initial or continuing qualification of the organization as a tax-exempt entity; (2) to determine whether the organization was qualified to receive tax-deductible contributions; and (3) to determine whether the organization was subject to the provisions of the Code regarding unrelated business taxable income. Once it had been determined that an organization was a church, no further examination of its religious activities could be made in connection with determining its liability for tax on unrelated business income. Treas. Reg. sec. 301.7605-1(c)(3).

Prior law did not require an IRS regional commissioner to give special notice before examining the religious activities of a church for the purposes described above. However, the IRS had administratively adopted such a procedure (Internal Revenue Manual 7(10)71.21(4)).

Period of limitations for assessment or collection of tax

Under the general limitation provisions of the Code (sec. 6501), the IRS is required to assess income taxes, or to initiate a proceeding for collection without assessment, within three years after a return is filed. Where a taxpayer fails to file a return, the three-year limitation is inapplicable, and tax may be assessed at any time. Tax also may be assessed at any time in the case of a false or fraudulent return, or a willful attempt to defeat or evade tax in any manner. Under prior law, these general periods of limitation also applied to assessment of church tax liabilities.

Declaratory judgment actions

A taxpayer is allowed to bring a declaratory judgment action in any case involving a determination of tax-exempt status under the Code (including an adverse IRS determination or failure to make a determination) (sec. 7428). The action may be brought in the Tax Court, the Claims Court, or the United States District Court for the District of Columbia. These courts may issue a declaratory judgment only upon determining that the taxpayer has exhausted administrative remedies available within the IRS. This generally requires a final adverse determination by the IRS; however, an organization is deemed to have exhausted its administrative remedies if the IRS fails to make a determination within 270 days after the determination was requested and the organization has taken all timely and reasonable steps to secure a determination.

Taxpayers generally are prohibited from seeking injunctions against assessment or collection of tax (sec. 7421).

Reasons for Change

Congress' actions concerning church tax inquiries and examinations were motivated by two competing considerations. First, Congress was aware of the special problems, including problems of separation of church and state and the special relationship of a church to its members, that arise when the Internal Revenue Service (or any governmental agency) examines the records of a church. These problems may be compounded by the relative inexperience of churches in dealing with the IRS and the resulting occasional misunderstandings between churches and the IRS. While prior law imposed limitations on the examination of church records, these limitations were somewhat vague and relied heavily on internal IRS procedures to protect the rights of a church in the examination process. Additionally, there was some uncertainty regarding the scope of the investigations to which prior law applied and the nature of the records that were protected by the law.

While desiring to protect churches from undue interference by the IRS, Congress recognized that an increasing number of taxpayers had, in recent years, utilized the church form primarily as a tax-avoidance device. Congress believed that the IRS must retain an unhindered ability to pursue individuals who use the church form in this manner. The Act attempts to resolve these competing considerations by providing detailed rules that the IRS is to follow in making tax inquiries to churches, both as to tax-exempt status and as to the existence of unrelated business income. These provisions emphasize the need for a speedy determination of church tax liabilities and, where possible, a determination without unnecessary examination of church books and records. Congress believed that these provisions will protect the rights of legitimate churches without unduly hindering IRS efforts to eliminate tax-avoidance schemes posing as religious organizations. Further, the Congress believed that the adoption of detailed statutory rules will reduce misunderstandings between churches and the IRS and allow for a more stable and cooperative examination process.

Explanation of Provisions

Overview

The Act provides that the IRS may investigate an organization claiming to be a church only if an IRS regional commissioner *reasonably* believes, on the basis of facts and circumstances recorded in writing, that the organization is engaged in taxable activities or does not qualify for tax-exemption. The Act also provides expanded notice requirements that must be satisfied before the IRS may examine any church records, including a requirement that church officials have an opportunity to meet with IRS representatives before an examination of such records. Finally, the Act adds special procedural provisions designed to hasten the determination of church tax liabilities, including a requirement that church tax inquiries and examinations generally be completed within two years after commencement.

Requirement of reasonable belief before commencing a church tax inquiry

The Act provides that the IRS may begin a church tax inquiry or examination only if the IRS regional commissioner (or a higher official) reasonably believes, on the basis of facts and circumstances recorded in writing, that an organization (1) may not qualify for tax-exemption as a church, (2) may be carrying on an unrelated trade or business (within the meaning of section 513 of the Code), or (3) otherwise may be engaged in taxable activities. A church tax inquiry is defined as any inquiry to a church (other than an examination) that serves as a basis for determining whether the organization qualifies for tax-exemption as a church or whether it is carrying on an unrelated trade or business or otherwise is engaged in taxable activities. An inquiry is considered to commence when the IRS requests information or materials from a church of a type contained in church records, other than routine requests for information or inquiries regarding matters that do not primarily concern the tax status or liability of the church itself. Congress intended that the facts and circumstances that form the basis for a reasonable belief under this provision will be derived from information lawfully obtained by the IRS. Information obtained from informants used by the IRS for this purpose must not be known to be unreliable.

Notice requirement upon commencement of inquiry

Under the Act, upon beginning a church tax inquiry, the IRS is required to provide written notice to the church of the beginning of the inquiry. This notice must include (1) an explanation of the concerns that gave rise to the inquiry and the general subject matter of the inquiry, (2) a general explanation of the provisions of the Internal Revenue Code that authorize the inquiry or that otherwise may be involved in the inquiry, and (3) a general explanation of administrative and constitutional provisions applicable to the inquiry, including the right to a conference with the IRS before an examination of church records takes place.

The explanation of the concerns and general subject matter of the inquiry (item (1) above) must be specific enough to allow the church to understand the particular area of church activities or behavior that is at issue in the inquiry. For example, for an inquiry regarding unrelated business income, this initial notice should indicate the general activities of the church that may result in such income (e.g., use of a particular property or facility for other than tax-exempt purposes). For an inquiry regarding tax-exempt status, the notice should indicate those general aspects of the church's operations or activities that have given rise to questions regarding its tax-exempt status. The IRS is not precluded from expanding its inquiry beyond the concerns expressed in the notice as a result of facts and circumstances that subsequently come to its attention (including, where appropriate, an expansion of an unrelated business income inquiry to include questions regarding tax-exempt status, or *vice-versa*).

The notice requirement is not to be interpreted to require the IRS to share particular items of evidence with the church, or to identify its sources of information regarding church activities, where providing such information would be damaging to the inquiry or to the sources of IRS information. For example, in an inquiry regarding unrelated business income, the IRS might indicate that its inquiry was prompted by a local newspaper advertisement regarding a church-owned business; however, the IRS would not be required to reveal the existence or identity of any so-called "informers" within a church (including present or former employees).

The general explanation of applicable administrative and constitutional provisions (item 3) should make reference to the various stages of the church tax inquiry and examination procedures contained in the Act (including the right to a pre-examination conference) and the principle of separation of church and state under the First Amendment. The explanation is not required to explain the possible legal or constitutional ramifications of any particular church inquiry or examination.

For purposes of this and the remaining church tax inquiry and examination procedures, a church includes (1) any organization claiming to be a church, or (2) a convention or association of churches. For purposes of these procedures, a church does not include church-supported schools or other organizations incorporated separately from the church.

Second notice and offer of IRS conference

Under the Act, the IRS may examine church records or religious activities only if, at least 15 days before the examination, the IRS provides written notice to the church and to the IRS regional counsel of the proposed examination. This tax examination notice is in addition to the tax inquiry notice previously provided to the church.

The notice of examination is required to include (1) a copy of the church tax inquiry notice previously provided to the church, (2) a description of the church records and activities that the IRS seeks to examine, and (3) a copy of all documents that were collected or prepared by the IRS for use in the examination and that are required to be disclosed under the Freedom of Information Act (5 U.S.C. sec 552), as supplemented by section 6103 of the Code (relating to disclosure and confidentiality of tax return information). Congress intended that the documents supplied under this provision will be limited to documents specifically concerning the church whose records are to be examined and will not include documents relating to other inquiries or examinations or to IRS practices and procedures in general. Congress further intended that disclosure to the church will be subject to the restrictions of applicable law (including FOIA and the Code) regarding the disclosure of the existence or identity of informers. The description of materials to be examined included in the notice of examination and the documents disclosed by the IRS to the church are not intended to restrict the ability of the IRS to examine the church records or religious activities that are properly within the scope of the examination.

The Act further requires the IRS regional commissioner, as part of the notice of examination, to offer the church an opportunity to meet with an IRS official to discuss the concerns that gave rise to the inquiry and the general subject matter of the inquiry. The organization may request such a meeting at any time prior to commencement of the examination. If the church requests a meeting, the IRS is required to schedule a meeting within a reasonable time and may proceed to examine church records only after the meeting. Congress intended that holding one meeting with the church will be sufficient to satisfy the requirements of this provision. Congress further intended that churches not be permitted to utilize the meeting requirement in order to delay unreasonably an examination.

The purpose of the meeting between the church and the IRS is to encourage discussion of the relevant issues that may arise as part of the inquiry and examination in an effort to resolve the issues of tax exemption or liability without the necessity of an examination of church records. Congress therefore intended that the church and the IRS make a reasonable effort to resolve outstanding issues at the meeting. To avoid misunderstandings, Congress intended that the IRS remind the church at the meeting, in general terms, of the church tax inquiry and examination procedures and the church's rights under such procedures. However, the IRS is not required to reveal information at the meeting of a type properly excludable from a written notice (including information regarding the identity of third-party witnesses or evidence provided by such witnesses).

The notice of examination may not be sent to a church fewer than 15 days after the notice of commencement of a church tax inquiry. Thus, at least 30 days must pass between the first notice and the actual examination of church records. For example, if notice of commencement of an inquiry is sent to a church on day 1, a notice of examination may be sent to the church no earlier than day 15, and no examination of church records may be made before day 30. If an organization does not request a meeting before day 30, the IRS may proceed to examine church records.

If the IRS does not send a notice of examination within 90 days after sending the notice of inquiry, the inquiry will be considered terminated. Congress intended that this 90-day period be suspended during any period for which the two-year period of limitations on the duration of a church tax inquiry and examination is suspended; however, the 90-day period is not to be suspended because of the church's failure to comply with requests for information made before the notice of examination. If the inquiry is terminated under this provision, any further inquiry regarding the same or similar issues within a five-year period requires approval of the IRS Assistant Commissioner (Employee Plans and Exempt Organizations).

Notification of regional counsel

At the same time as notice of an examination is provided to a church, the IRS is required to provide a copy of the same notice to the appropriate IRS regional counsel. The regional counsel then is allowed 15 days from issuance of the notice in which to file an advisory objection to the examination. (This period is concurrent with the 15-day period during which the IRS is prohibited from examining church records.) Congress intended that the regional commissioner will take any objection by the regional counsel into account in determining whether to proceed with an examination.

Definition of protected church records

The Act provides that the IRS may examine church records only to the extent necessary to determine the liability for, and the amount of, any Federal tax. Church records include all regularly kept church corporate and financial records, including (but not limited to) corporate minute books, contributor or membership lists, and any materials that qualified as church books of account under prior law. Congress further intended that the term church records include private correspondence between a church and its members that is in the possession of the church. Church records protected by the Act do not include records previously filed with a public official or, as under prior law, newspapers or newsletters distributed generally to the church members.

Records held by third parties (e.g., cancelled checks or other records in the possession of a bank) are not considered church records for purposes of the Act. Thus, subject to the general Code provisions regarding third party summonses, the IRS is permitted access to such records without regard to the requirements of the church tax inquiry and examination procedures (sec. 7609). Under the general Code rules, either the IRS or a third party recordkeeper generally is required to inform a church of any IRS requests for such materials.

The Act provides that the IRS may not determine that a church is not entitled to tax-exemption or assess tax for unrelated business income against a church solely on the basis of third party records (i.e., without complying with the church tax inquiry and examination procedures). This limitation does not apply to assessments of tax other than assessments for unrelated business income (e.g., for social security or other employment taxes). Congress intended that the IRS not use information obtained from third party bank records to avoid the purposes of the church tax inquiry and examination procedures.

The Act provides that, as under prior law, the IRS may examine the religious activities of an organization claiming to be a church (including a convention or association of churches) only to the extent necessary to determine if the organization actually is a church. The Act clarifies that this includes a determination of the organization's qualification as a church for any period of time.

Time limit on church tax inquiries and examinations

The Act requires the IRS to complete any church tax inquiry and examination, and to make a final determination with respect thereto, no later than two years after the date on which the notice of examination is supplied to the church. The running of this two-year period is suspended for any period during which (1) a judicial proceeding brought by the church or its agents against the IRS with respect to the church tax inquiry or examination is pending or being appealed, (2) a judicial proceeding brought by the IRS against the church (or any official thereof) to compel compliance with any reasonable IRS request for examination of church records or religious activities is pending or being appealed, or (3) the IRS is unable to take actions with respect to the church tax inquiry or examination by reason of an order issued in a suit involving access to third-party records. The two-year period also is suspended for any period in excess of 20 days (but not in excess of 6 months) in which the church or its agents fail to comply with any reasonable IRS request for church records or other information.

The Act allows the two-year period to be extended by mutual agreement of the church and the IRS.

Period for assessment and collection of tax

Under the Act, for examinations regarding revocation of tax-exempt status where no return has been filed, the IRS is limited initially to an examination of church records that are relevant to a determination of tax status or liability for the three most recent taxable years preceding the date on which the notice of examination (i.e., second notice) is sent to the church. If the church is not exempt for any one or more of those years, the IRS may examine relevant records and assess tax (or proceed without assessment), as part of the same examination, for a total of six years preceding the date of the notice of examination.

For examinations relating to unrelated business taxable income if no return has been filed, the IRS may assess or collect tax for the six most recent years preceding the date on which the notice of examination is sent, with no additional limit on the period of church records which may be examined.

For examinations involving issues other than revocation of exempt status or unrelated business income (e.g., examinations relating to social security or other employment taxes), no special limitation applies if no return has been filed.

The special periods of limitations for church tax liabilities are not to be construed to increase an otherwise applicable period of limitations if a return was filed by the church. Thus, a three-year limitation period will apply where a church filed a tax return before an examination was held and did not substantially understate income.

The special periods of limitation for churches do not apply in any case of fraud, willful tax evasion, or knowing failure to file a return which should have been filed.

As under prior law, the applicable period of limitations may be extended by mutual agreement of the church and the IRS.

Declaratory judgment actions regarding tax-exempt status

Under the Act, an organization is entitled to bring a declaratory judgment action once the IRS issues a revenue agent's final report ("30-day letter") proposing to revoke a church's tax-exempt status.

Regional counsel approval of final IRS determinations

The Act requires the appropriate IRS regional counsel to approve, in writing, (1) any determination of whether an organization does not have tax-exempt status as a church (sec. 501(a), (2) any determination of whether such an organization is not a church that is entitled to receive tax-deductible contributions (sec. 170(c)), or (3) the issuance of a notice of deficiency to a church following a church tax examination (or, in cases where deficiency procedures are inapplicable, the assessment of any underpayment of tax by the church). The Act further requires the regional counsel to state in writing that the IRS has complied substantially with the church tax inquiry and examination procedures provided by the Act.

Prevention of repeated examinations

The Act requires the IRS Assistant Commissioner (Employee Plans/Exempt Organizations) to approve, in writing, any second tax inquiry or examination of a church, unless the first tax inquiry or examination resulted in (1) revocation of tax-exemption or an assessment of tax, or (2) a request by the IRS for significant changes in church operational practices (including the adequacy or sufficiency of records maintained to reflect income). The requirement of assistant commissioner approval does not apply where the second church tax inquiry or examination does not involve the same or similar issues as the preceding inquiry or examination. Additionally, the requirement applies only to second examinations beginning within five years of the date on which the notice of examination was sent to the church during the prior examination (or, if no notice of examination was sent, the date of the notice of commencement of inquiry). This five-year period is suspended for periods during which the two-year period for completion of an inquiry or examination is suspended under the Act (unless the prior inquiry or examination actually was concluded within two years of the notice of examination).

Congress intended that, in determining whether a second inquiry or examination involves similar issues to a prior inquiry or examination, the substantive factual issues involved rather than legal classifications will govern. For example, Congress intended that unrelated business income from different sources will be considered different issues for purposes of this provision.

Scope of church tax inquiry and examination procedures

The Act specifies that the special church tax procedures do not apply (1) to any inquiry or examination of any person other than a church, (2) to any termination assessment (sec. 6851) or jeopardy assessment (sec. 6861), or (3) to any case involving a knowing failure to file a return or a willful attempt to defeat or evade tax. Additionally, the Act provides that these procedures do not apply to criminal investigations.

Congress intended that inquires or examinations that relate primarily to the tax status or liability of persons other than the church (including the tax status or liability of a contributor or contributors to the church), rather than the tax status or liability of the church itself, not be subject to the church tax inquiry and examination procedures. These inquiries or examinations may include, but are not limited to, (1) inquiries or examinations regarding the inurement of church funds to a particular individual or to another organization, which inurement may result in the denial of all or part of such individual's or organization's deduction for contributions to the church, (2) inquiries or examinations regarding the assignment of income or services or excessive contributions to a church, and (3) inquiries or examinations regarding a vow of poverty by an individual or individuals followed by a transfer of property or an assignment of income or services to the church. The IRS may inquire of a church regarding these matters without being considered to have commenced a church tax inquiry and may proceed to examine church records relating to these issues (including enforcement of a summons for access to such records) without following the requirements applicable to church tax examinations, subject to the general Code rules regarding examinations of taxpayer books and records.

Congress intended that inquiries or examinations conducted outside of the church tax inquiry and examination procedures be limited to the determination of facts and circumstances specifically relating to the tax liabilities of the individuals or other organizations in question. For example, in an inurement case, the IRS may request information or examine church records regarding amounts of money, property, or services transferred to the individual or individuals in question (including wages, loans, or noncontractual transfers), the use of church funds for personal expenses, or other similar matters, outside of the church tax inquiry and examination procedures. Likewise, in an assignment of income case, the IRS may request information or examine church records relevant to an individual's assignment of particular income, donation of property, or transfer of a business to a church. However, the IRS may not examine a contributor or membership list in the possession of the church, without following the special church tax procedures, for the purpose of determining the overall financial structure of the church, merely because such structure was relevant to the church's qualification as a tax-exempt entity and therefore indirectly relevant to the validity of contributors' deductions in general. Congress further intended that the IRS will not make use of inquiries or examinations regarding individuals' or other organizations' tax liabilities to avoid the intended purpose of the special church tax procedures. However, failure of a church to respond to repeated inquiries regarding individuals' or other organizations' tax liabilities may be considered a reasonable basis for commencement of a church tax inquiry.

Routine IRS inquiries to a church are not considered to commence a church tax inquiry and therefore do not trigger the special church tax procedures. Routine questions for this purpose include (but are not limited to) questions regarding (1) the filing or failure to file any tax return or information return by the church, (2) compliance with income tax or FICA tax withholding responsibilities by the church, (3) any supplemental information needed to complete the mechanical processing of any incomplete or incorrect return filed by the church, (4) information necessary to process applications for exempt status, letter ruling requests, or employment tax exemption requests by the church, (5) information identifying a church that is used by the IRS to update its Cumulative List of Tax Exempt Organizations and other computer files, or (6) confirmation that a specific business is or is not owned or operated by a church. As in the case of inquiries regarding individuals, repeated failure by a church or its agents to reply to such routine inquiries is considered to be a reasonable basis for commencement of a church tax inquiry under the special church tax procedures. The IRS further may request a church to provide information necessary to locate third-party records (e.g., bank records), including information regarding the church's chartered name, State and year of incorporation, and location of checking and savings accounts, without following the special church tax procedures. Failure by the church to provide this type of information is to be a factor, but not a conclusive factor, in determining if there is reasonable cause for commencing a church tax inquiry.

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The Act specifies that the special church tax procedures do not apply to any case involving a knowing failure to file a return or a willful attempt to defeat or evade tax. Congress was aware that, in recent years, increasing numbers of tax protestors and other taxpayers have utilized the form of religious organizations in an effort to avoid tax. In Fiscal Year 1984, the IRS closed 10,900 examinations involving alleged church tax avoidance schemes, assessing $51,930,000 in taxes and penalties (an average assessment of $4,800 per return) and leaving a calendar year-end inventory of 28,300 church tax avoidance cases (in addition to approximately 250 criminal investigations).

Congress specifically intended that nothing in the church tax inquiry and examination procedures inhibit IRS inquiries, examinations, or criminal investigations of tax protestor or other tax avoidance schemes posing as religious organizations, including (but not limited to) tax avoidance schemes posing as mail-order ministries or storefront churches, whether such schemes are limited to one particular taxpayer or encompass a group of taxpayers.

Exclusive remedy for IRS violation of special church tax procedures

The Act provides that the *exclusive* remedy for any IRS violation of the church tax inquiry and examination procedures described above is as follows: Failure of the IRS to comply substantially with (1) the requirement that two notices be sent to the church, (2) the requirement that a regional commissioner approve the commencement of a church tax inquiry, or (3) the requirement that an offer of an IRS conference with the church be made (and a conference held if requested), results in a stay in a summons proceeding to gain access to church records (but not in dismissal of such proceeding) until these requirements are satisfied.

The two-year limitation on duration of a church tax inquiry or examination is not to be suspended during stays of summons proceedings resulting from the violations described above. Additionally, the IRS may correct such violations without regard to the otherwise applicable time limits prescribed under the church tax inquiry and examination procedures. Congress intended that, in determining whether a stay is necessary, a court will consider the good faith of the IRS and the effect on the church's rights of any violation of the proper tax inquiry and examination procedures.

Aside from the exclusive remedy described above, there is to be no judicial remedy for IRS violation of any of the church tax inquiry and examination procedures provided by the Act, and IRS failure to comply with any of these requirements may not be raised as a defense or an affirmative ground for relief in any judicial proceeding, including, but not limited to, a summons proceeding to gain access to church records, a declaratory judgment proceeding involving a determination of tax-exempt status, or a proceeding to collect unpaid tax. Failure to comply substantially with the requirement that two notices be sent, that the regional or assistant commissioner approve an inquiry, and that a conference be offered (and the conference held if requested) may not be raised as a defense or as an affirmative grounds for relief in a summons proceeding or any other judicial proceeding other than as specifically set forth above.

Additionally, Congress specifically intended that a church or its representatives not be able to litigate the issue of the reasonableness of the belief in approving the commencement of a church tax inquiry (i.e., the belief that the church may not be tax-exempt or may be engaged in taxable activities) in any summons proceeding or any other judicial proceeding.

Finally, Congress intended that these provisions not derogate from a church's right to raise any substantive or procedural argument that is available to taxpayers generally in the appropriate proceeding.

Effective Date

The church tax inquiry and examination procedures are effective for inquiries and examinations commencing after December 31, 1984.

Revenue Effect

These provisions are estimated to have a negligible effect on fiscal year budget receipts.

4. Acquisition Indebtedness of Certain Educational Institutions (sec. 1034 of the Act and sec. 514 of the Code)[37]

Prior Law

A qualified pension trust or an organization that is otherwise exempt from Federal income tax generally is taxed on any income from a trade or business that is unrelated to the organization's exempt purposes (Code sec. 511). Specific exclusions from the tax are provided for certain types of income, including rents, royalties, dividends, and interest, except where such income derives from "debt-financed property." Any income from debt-financed property generally is subject to tax as unrelated business income in the proportion in which the property is financed by debt (sec. 514(a)).

Debt-financed property is defined as any property held to produce income with respect to which there is acquisition indebtedness at any time during the taxable year, or during the 12 months prior to disposition if the property is disposed of during the taxable year (sec. 514(b)). A debt constitutes acquisition indebtedness if it was incurred in acquiring or improving the property, or if the debt would not have been incurred but for the acquisition or improvement of the property (sec. 514(c)).

Under a prior-law exception to these rules, indebtedness incurred by a qualified pension trust as a result of the acquisition or improvement of real property was not considered acquisition indebtedness (sec. 514(c)(9)). Thus, income or gain received from, or with respect to, such debt-financed real property was not taxable. However, this exception did not apply (and hence such income was taxable) if any of the following conditions existed: (1) the acquisition price was not a fixed amount determined as of the date of acquisition; (2) the amount of the indebtedness, or the amount payable thereon, or the time for making any payments, was dependent (in whole or in part) on revenues derived from the property; (3) the property was leased by the qualified pension trust to the seller or a person related to the seller; (4) the property was acquired by the qualified trust from a person related to the plan under which the trust was formed, or such property was leased to such a related person; and (5) the seller, a person related to the seller, or a person related to the plan provided nonrecourse financing for the transaction, and the debt was subordinate to any other indebtedness on the property or the debt bore a less than arm's-length interest rate.

[37] For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 865; S. Prt. 98-169, Vol. I (April 2, 1984), p. 848-49; and H. Rep. No. 98-861 (June 23, 1984), p. 1096-98 (Conference Report).

Reasons for Change

The Congress believed that the special exception from the unrelated business income tax for income derived from debt-financed property held by qualified pension trusts should be extended to educational organizations. Under prior law, educational organizations generally were unable to avoid taxation on income from real property acquired for investment purposes because few institutions had sufficient assets to purchase property not subject to debt.

However, the Congress believed that the prior-law restrictions on the application of the debt-financed real property exception were inadequate to prevent the shifting of tax benefits between tax-exempt organizations and taxable entities. For example, prior law did not prevent a pension trust, in partnership with a taxable entity, from shifting its unused ACRS deductions on debt-financed real property to its taxable partner. In effect, such a transaction permitted taxable entities to benefit from the favorable treatment accorded to pension trusts under the debt-financed real property exception. The Congress recognized that the debt-financed property exception was originally enacted to benefit tax-exempt pension trusts and not to permit the shifting of tax benefits to taxable entities. Thus, the Congress found it appropriate, in addition to expanding the exception to certain educational organizations, to impose additional requirements that must be met by all eligible organizations in order to qualify for the exception.

Explanation of Provision

Under the Act, the exception in Code section 514(c)(9) to the debt-financed property rules for real property held by qualified pension trusts is extended to real property held by educational institutions (as defined in sec. 170(b)(1)(A)(ii)) and certain affiliated support organizations. This exception does not apply to any organization (including a qualified pension trust) if (1) the price for acquisition or improvement is not a fixed amount determined as of the date of acquisition or of completion of the improvement; (2) the amount of the indebtedness (or any other amount payable thereon) or the time for making any payments of such amounts, is dependent (in whole or in part) on the revenues, income, or profits derived from the property; (3) property is leased by the organization to the seller or a person related (under secs. 267(b) or 707(b)) to the seller; (4) in the case of a qualified trust, the property is acquired by the trust from, or leased by the trust to, a person related to the plan under which the trust is formed or to certain other persons;[38] or (5) the seller or a person related to the seller (as defined in (3) or (4), above) provides financing in connection with the acquisition.

In addition, the Act provides that an organization which is a partner in a partnership that holds real property can qualify for

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[38] A person is related to the plan, under which the trust is formed if the person is (1) the employer maintaining the plan, (2) a 50-percent owner of the employer maintaining the plan, (3) a corporation, partnership, trust, or estate that is at least 50-percent owned by a fiduciary with respect to the plan, a person providing services to the plan, an employee organization, the employer, or a 50-percent owner of the employer, or (4) a member of the family of, or an officer, director, 10-percent shareholder, or highly compensated employed of, a person described in (1), (2), or (3).

the exception to the debt-financed property rules only if either (1) all of the partners of the partnership are organizations qualifying for the exception, or (2) each allocation to a partner of the partnership which is a qualified organization is a qualified allocation.[39] For purposes of (1), an organization is not treated as a organization qualifying for the exception if any of such organization's income is unrelated business taxable income determined without regard to income that otherwise would be eligible for the exception under section 514(c)(9). Accordingly, if a partner is an educational organization or a pension trust that has unrelated business taxable income for the taxable year, the partner is not an organization qualifying for the exception and, therefore, an allocation to a partner that is a qualified organization must be a qualified allocation.

For purposes of these rules, an allocation generally constitutes a qualified allocation if it meets the rules relating to partnership allocations under the tax-exempt leasing provisions (sec. 168(j)(9)). Thus, a qualified allocation is an allocation under which (1) the qualified organization is allocated the same percentage share of each item of partnership income, gain, loss, deduction, credit, and basis (excluding allocations with respect to contributed property), (2) such share remains the same during the entire period that the organization is a partnership, and (3) such allocation has a substantial economic effect, as defined under the rules applicable to partnership allocations generally (sec. 704(b)(2)).

Under the Act, the Treasury is to prescribe regulations dealing with the effect of guaranteed payments (as defined in sec. 707(c)) under this rule. Under those regulations, priority cash distributions to partners that constitute guaranteed payments should not disqualify an otherwise qualified allocation as long as the priority cash distributions are reasonable in amount (e.g., equal to the most appropriate Federal rate) and are made to all partners in proportion to their capital in the partnership. On the other hand, the regulations are expected to prevent partnerships from avoiding the qualified allocation rules by making disproportionately large guaranteed payments to its tax-exempt partners for the use of their capital.

The Act provides that the Treasury shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of the unrelated debt-financed income provisions (Code sec. 514), including regulations to prevent the circumvention of these provisions through the use of segregated asset accounts. It is intended that such regulations are to be applied only with respect to transactions entered into after the date on which any regulations relating to this provision are issued.

Effective Date

The provision generally is effective with respect to indebtedness incurred after the date of enactment (July 18, 1984). Two partnership transitional rules are provided.

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[39] Similar rules are to apply in the case of any other pass-thru entity and in the case of tiered partnerships or other tiered entities.

Under the first transitional rule, the amendments to Code section 514 made by the Act do not apply to indebtedness incurred before January 1, 1985, by certain partnerships if the indebtedness is incurred with respect to property acquired (directly or indirectly) by the partnership before January 1, 1985. A partnership is eligible under this transitional rule if (1) before October 21, 1983, the partnership was organized, a request for a prohibited transaction exemption was filed with the Department of Labor, and a private placement memorandum stating the maximum number of units in the partnership that would be offered for sale had been circulated, (2) the interest in the property to be acquired, directly or indirectly (including through acquiring an interest in another partnership) by such partnership, was described in such private placement memorandum, and (3) the marketing of partnership interests in the partnership is completed not later than two years after the date of enactment or the date of publication in the Federal Register of the exemption by the Department of Labor and the aggregate number of units in the partnership that are sold does not exceed the amount described in (1).

The second transitional rule provides that the amendments to Code section 514 made by the Act do not apply to any indebtedness incurred before January 1, 1986, by certain partnerships if the indebtedness is incurred with respect to property acquired (directly or indirectly) by the partnership before January 1, 1986. A partnership is eligible under this second transitional rule if (1) before March 6, 1984, the partnership was organized and publicly announced the maximum amount of interests that would be sold in the partnership, and (2) the marketing of partnership interests in the partnership is completed not later than the 90th day after the date of enactment and the aggregate amount of interests in the partnership sold does not exceed the maximum amount described in (1). The maximum amount of interest that would be sold means the greatest of the amounts shown in the registration statement, prospectus, or partnership agreement. Under this transitional rule, property is considered to have been acquired before January 1, 1986, if the property is acquired pursuant to a written contract that, on January 1, 1986, and at all times thereafter, required the acquisition of property and the property is placed in service not later than six months after the date the contract was entered into.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by $24 million in 1984, $46 million in 1985, $58 million in 1986, $73 million in 1987, $91 million in 1988, and $114 million in 1989.

5. Expansion of Circumstances in Which a Deduction May Be Claimed for Qualified Conservation Contributions (sec. 1035 of the Act and secs. 170, 2055, and 2522 of the Code)[40]

Prior Law

Charitable contributions generally

Subject to certain limitations, a deduction is permitted for contributions of property to charitable organizations, to the United States, or to a State or local government. The deduction generally is equal to the fair market value of the property on the date of the contribution. Charitable deductions are provided for income, estate, and gift tax purposes (Code secs. 170, 2055, and 2522).

Gifts of certain types of property interests are subject to special restrictions, either as to the amount deductible or as to the types of property interests for which a deduction is permitted. For example, a contribution of less than the donor's entire interest in property generally does not give rise to a charitable deduction (for income, estate, or gift tax purposes) unless the gift takes the form of an interest in a unitrust, annuity trust, or a pooled income fund. Exceptions to the partial interest rule are provided for gifts of remainder interests in farms or personal residences, gifts of undivided portions of the donor's entire interest in the property, and for gifts of qualified conservation interests.

Qualified conservation interests

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

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

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

c. The preservation of open space (including farmland and forest land) but only if such preservation either (1) is for the scenic enjoyment of the general public, or is pursuant to a clearly delineated Federal, State, or local governmental conservation policy, and (2) will yield a significant public benefit; or

d. The preservation of an historically important land area or a certified historic structure (sec. 170(h)).

Deductible conservation interests may take any of three forms. First, the value of a remainder interest is deductible. Second, the value of a restriction (e.g., an easement) granted in perpetuity on the use of the property is deductible. Finally, the contribution of

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[40]For the legislative background of the provisions see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 806; S. Prt. 98-169, Vol. I (April 2, 1984), p. 726; and H. Rep. No. 98-861 (June 23, 1984), p. 1083 (Conference Report).

the donee's entire property interest is deductible, except that the donor may retain his or her interest in subsurface oil, gas, or other minerals and the right of access to such minerals. Under prior law, surface mining was required to be precluded on the property at all times.

Reasons for Change

Congress believed that the general restrictions governing the deductibility of qualified conservation contributions, as enacted in 1980, remain appropriate today. However, it was brought to Congress' attention that certain historical patterns of land ownership in some areas precluded realization of this incentive to the preservation of America's natural habitats in those areas. Therefore, Congress determined that a narrow exception to the prohibition on surface mining was justified in certain cases.

Explanation of Provision

The Act creates a narrow exception to the general rule precluding any deduction for a conservation contribution if there is any possibility of surface mining occurring at any time on the land with respect to which the contribution relates. Under this exception, deductions for contributions of conservation interests satisfying all requirements of prior law other than the complete prohibition on surface mining will be permitted if two conditions are satisfied.

First, the surface and mineral estates in the property with respect to which the contribution is made must have been separated before June 13, 1976. This separate ownership must have been continuous at all times after June 12, 1976. If the ownership of the surface and mineral estates in property first become separated after June 12, 1976, and surface mining is not completely precluded, a contribution of a restriction on the property will not qualify as a conservation contribution. In addition, this first condition is not satisfied if (1) the owner of the surface interest at any time transferred (directly, or indirectly through a person related to the original transferor) the mineral interests to the person who owns those interests at the time the conservation contribution is made, or (2) the present owner of those interests is related to the owner of the surface estate. Congress anticipated that the Treasury Department will define the term related party in a manner similar to the definition contained under Code section 267.

The second condition that must be satisfied if a deduction is to be allowed under the exception is that the probability of surface mining on the property with respect to which a contribution is made must be so remote as to be negligible. Congress intended that the Treasury Department is to issue regulations defining the circumstances under which the probability of surface mining occurring is so remote as to be negligible. Congress recognized that the determination of remoteness is factual and must be made on a case by case basis. However, it was anticipated that important factors in this determination will be whether the mineral interests have any commercial value or are likely to have such value under any reasonably foreseen circumstances; the nature and extent of any mineral deposits on the property; and, the character of the owner of such interests (e.g., a mining company as opposed to a governmental unit).

Effective Date

This provision is effective on the date of enactment (July 18, 1984), with respect to conservation contributions made after that date.

Revenue Effect

This provision is estimated to reduce fiscal year budget receipts by $5 million annually during the period 1985 through 1989.

E. Income Tax Credits

1. Extension of Targeted Tax Jobs Credit (sec. 1041 of the Act and sec. 51 of the Code)[41]

Prior Law

Background

The targeted jobs tax credit was enacted in the Revenue Act of 1978 as a substitute for the expiring credit for increased employment (the "new jobs credit"). The new jobs credit was available in 1977 and 1978.

As initially enacted, the targeted jobs credit was intended to be available for qualified wages paid before 1982.[42] The Economic Recovery Tax Act of 1981 (ERTA) extended the availability of the targeted jobs credit to qualified wages paid to individuals beginning work for the employer before 1983. The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) extended the availability of the credit to qualified wages paid to individuals who begin work for the taxpayer before 1985. Also, TEFRA authorized the appropriation for fiscal years 1983 and 1984 of such sums as might be necessary for the expenses of administering the certification system and of providing publicity regarding the targeted jobs credit to employers.

ERTA and TEFRA also altered the targeted group definitions and made several administrative changes in the credit provisions.

Targeted jobs credit rules

The targeted jobs tax credit is available on an elective basis for hiring individuals from one or more of nine targeted groups. The targeted groups are (1) vocational rehabilitation referrals; (2) economically disadvantaged youths (ages 18–24); (3) economically disadvantaged Vietnam-era veterans; (4) SSI 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 aged 16 or 17. (Age was tested on the hiring date for purposes of this last targeted group.) In general, an individual was not treated as a member of a targeted group unless certification that he was a member of such a group was received or requested in writing by the employer from

[41] For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 856; S. Prt. No. 98-169, Vol I (April 2, 1984), pp. 817-18; Senate floor amendment, 130 Cong. Rec. S4315-16 (April 11, 1984); H. Rep. No. 98-861 (June 23, 1984), pp. 1253-54 (Conference Report); and H. Con. Res. 328, 130 Cong. Rec. S8948 (June 29, 1984), H7529 (June 29, 1984).

[42] As a result of a clerical error, the Revenue Act of 1978 limited the credit to wages paid before 1981. The error was corrected in the Technical Corrections Act of 1979

the local agency designated to perform certification on or before the day on which the individual begins work.

The credit generally is equal to 50 percent of the first $6,000 of qualified first-year wages plus 25 percent of the first $6,000 of qualified second-year wages paid to a member of a targeted group. Thus, the maximum credit is $3,000 per individual in the first year of employment and $1,500 per individual in the second year of employment. With respect to economically disadvantaged summer youth employees, however, the credit is equal to 85 percent of up to $3,000 of wages, for a maximum credit of $2,550. The employer's deduction for wages must be reduced by the amount of the credit.

The credit may not exceed 90 percent of the employer's tax liability after being reduced by certain other nonrefundable credits. Excess credits may be carried back three years and carried forward 15 years.

Reasons for Change

The Congress believed that experience with the targeted jobs credit since its enactment in 1978 had been sufficiently promising to warrant a further one-year extension of the credit. The Congress believed that such an extension would provide the Congress and the Treasury Department an opportunity to gather more information on the operation of the credit program so that its effectiveness as a hiring incentive could be more fully assessed.

The Congress also agreed to several technical amendments designed to clarify the credit rules and to correct certain shortcomings in those rules.

Explanation of Provision

The Act extends the targeted jobs credit for one additional year. Under the Act, the credit is available for qualified wages paid to individuals who begin work for the employer before January 1, 1986. Thus, for example, if an individual begins work on December 31, 1985, the employer may claim the credit for qualified first-year and qualified second-year wages paid to the individual for services performed in 1986 and 1987, respectively. The Act extends the authorization of appropriations for administrative expenses to fiscal year 1985.

The Act also makes several technical amendments to the targeted jobs credit rules. First, the Act extends the deadline for requesting certification of targeted group membership for a limited period. Under the Act, that deadline is five days after the day an individual begins work for an employer, provided that, on or before the day the individual begins work for the employer, the individual has received a written preliminary determination of targeted group eligibility (a "voucher") from the designated local agency (or other agency or organization designated pursuant to a written agreement with the designated local agency). The prior law rule—that certification must be requested no later than the day on which the employee begins work—was designed to prevent employers from retroactively claiming the credit for new employees whom the employers had hired earlier without regard to any incentive effect from the credit. However, this requirement was sometimes burdensome to employers, and the amendment is intended to ease the administrative burden involved in obtaining a certification. Since the amendment affects the certification only of those employees for whom a preliminary determination of credit eligibility has been made on or before the day they begin work for the employer, this amelioration of administrative burdens is not expected to weaken the rule's important objective of limiting the availability of the credit to circumstances in which the credit operates as an incentive to hire a targeted group individual.

Second, the Act provides that, under regulations prescribed by the Treasury, the determination of the credit for wages paid by a successor employer is to be made in the same manner as if the wages were paid by the predecessor employer.

Third, the Act allows the credit for remuneration paid by an employer to an employee for services performed for a person other than the employer only if the amount reasonably expected to be received by the employer from the recipient of the services exceeds the remuneration paid by the employer to the employee. This rule is intended to prevent employers from lending or donating the services of individuals on their payroll to tax-exempt or other organizations that would not have had sufficient tax liability to take advantage of the credit had they hired the individuals directly.

Fourth, the eligibility rules for the disadvantaged summer youth targeted group are amended to provide that an otherwise eligible youth must be aged 16 or 17 on May 1 of the calendar year concerned, rather than on the hiring date, if the hiring date was before May 1. Thus, a youth who is 17 when hired for summer employment, but who turns 18 before May 1, is not to be treated as a qualified summer youth.

Fifth, the Act repeals an obsolete provision relating to the starting date of the qualified first-year wage period for members of the vocational rehabilitation referrals targeted group.

Effective Date

In general, this provision applies to individuals who begin work for the employer after the date of enactment (July 18, 1984). The technical amendments with respect to employees who perform services for other persons and the age requirements for qualified summer youth eligibility apply to individuals who begin work for the employer after December 31, 1984.

Revenue Effect

This provision is estimated to reduce fiscal year budget receipts by $147 million in 1985, $380 million in 1986, $308 million in 1987, $160 million in 1988 and $93 million in 1989.

2. Changes in the Earned Income Credit (sec. 1042 of the Act and secs. 32 and 3507 of the Code)[43]

Prior Law

Under prior law, an eligible individual was allowed a refundable income tax credit generally equal to 10 percent of the first $5,000 of earned income, for a maximum credit of $500. However, the maximum allowable credit was phased down as adjusted gross income (or, if greater, earned income) rose above $6,000. Specifically, the credit was limited to the excess of $500 over 12.5 percent of the excess of adjusted gross income (or, if greater, earned income) over $6,000. Thus, under prior law, no credit was allowed for taxpayers with adjusted gross incomes or earned incomes over $10,000. So that eligible individuals will not have the burden of computing the amount of credit to be claimed on their returns, tables are used for determination of the credit amount. Eligible individuals may receive the benefit of the credit in their paychecks throughout the year by electing advance payments.

Earned income eligible for the credit includes all wages, salaries, tips, and other employee compensation, plus net earnings from self-employment. Amounts received as pension or annuity benefits may not be taken into account for purposes of the credit, nor is the credit available with respect to income of nonresident alien individuals which is not connected with a U.S. trade or business. For purposes of the credit, earned income is computed without regard to State community property laws.

Individuals eligible for the credit are married individuals filing joint returns who are entitled to a dependency exemption for a child, surviving spouses (who, by definition, must maintain a household for a dependent child), and heads of households who maintain a household for a child. In each case, for a taxpayer to qualify for the credit, the child must reside with the taxpayer in the United States. Furthermore, in order to claim the credit, an individual must not claim benefits under Code section 911 (relating to income earned by, and housing costs of, U.S. citizens and residents living abroad) or section 931 (relating to income from sources within possessions of the United States).

Reasons for Change

The Congress believed that the earned income credit is an effective way to provide relief from the social security and income tax burdens of low-income working families and thus to lessen the need

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[43] For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 868; S. Prt. No. 98-169, Vol. I (April 2, 1984), pp. 859-60; and H. Rep. No. 98-861 (June 23, 1984), pp. 1254-55 (Conference Report).

for supporting such families through large welfare payments. The credit, which was originally enacted in 1975, was last increased in 1978. The zero bracket amount, which also effectively provides income tax relief to low-income families, likewise has not been increased since 1978.

Because the purpose of the credit has been in part to offset social security taxes, and, thus, to provide a work incentive, the Congress believed it appropriate to increase the amount of the credit to take into account increases in social security taxes since 1978. Thus, the Congress decided that the rate of the credit should be increased from 10 percent to 11 percent. In addition, in order to provide some compensation for inflation since 1978, the Congress decided to raise the income level at which the credit begins to be phased out from $6,000 to $6,500, and to raise the income level at which the credit is fully phased out from $10,000 to $11,000.

It also came to the Congress' attention that some individuals with low earned income but substantial investment incomes had been claiming the credit. These individuals, who paid an alternative minimum tax rather than regular income tax, were technically eligible for the credit because various tax preferences reduced their adjusted gross income below the $10,000 level at which the credit was fully phased out. Since the earned income credit was never intended to benefit individuals with substantial economic income, the Congress decided to prevent such individuals from obtaining the credit.

Explanation of Provision

Under the Act, an eligible individual is allowed a refundable credit against Federal income tax equal to 11 percent of the first $5,000 of earned income; thus, the maximum allowable earned income credit is increased to $550. This amount is phased down as income rises above $6,500. Specifically, the credit is limited to the excess of $550 over 12-2/9ths percent of the excess of the taxpayer's adjusted gross income (or, if greater, earned income) over $6,500. Thus, the credit is not available to taxpayers with adjusted gross incomes or earned incomes exceeding $11,000. The Act makes conforming changes in the tables used for advance payments of the credit.

The Act also provides that the amount of the credit allowed for a taxable year is reduced by the amount of the taxpayer's liability for the alternative minimum tax for that year.

Effective Date

The changes in the earned income credit are effective for taxable years beginning after December 31, 1984.

Revenue Effect

This provision is estimated to increase outlays and reduce fiscal year receipts by $13 million in 1985, $373 million in 1986, $342 million in 1987, $315 million in 1988, and $290 million in 1989. (To the extent that the earned income credit exceeds tax liability, it is treated as an outlay under budget procedures.)

3. Alternative Test for Definition of Qualified Rehabilitated Building (sec. 1043 of the Act and sec. 48(g) of the Code)[44]

Prior Law

A three-tier system of rehabilitation credits is provided for qualified expenditures incurred in connection with certain buildings. The credit is equal to 15 percent of qualified expenditures in the case of buildings at least 30 years old, but fewer than 40 years old. In the case of buildings at least 40 years old, the credit is equal to 20 percent of qualified expenditures, and in the case of certified historic structures, the credit is equal to 25 percent of qualified expenditures. Qualified expenditures are, in general, capital expenditures made after December 31, 1981, for real property in connection with the rehabilitation of a qualified building. Costs of acquiring or enlarging a building are not included. With respect to a certified historic structure, the rehabilitation itself must be certified before expenditures may be considered qualified expenditures.

Under prior law, a building qualified for the rehabilitation credits only if (among other requirements) at least 75 percent of the building's external walls were retained in place as external walls after completion of the rehabilitation.

Reasons for Change

Congress believed that an alternative test to the 75-percent-of-external-wall test should be provided to enable buildings of other than square or rectangular shapes to qualify more readily for the rehabilitation credit.

Explanation of Provision

The Act provides an alternative test to the prior-law requirement that 75 percent of the building's external walls be retained in place as such. The alternative test requires that at least 50 percent of the building's external walls be retained in place as external walls, that at least 75 percent of the building's external walls be retained in place as either external walls or internal walls, and that at least 75 percent of the building's internal structural framework be retained in place.

Effective Date

The provision is effective for expenditures after December 31, 1983, in taxable years beginning after that date.

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[44] For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 860; S. Prt. 98-169, Vol. I (April 2, 1984), p. 822; and H. Rep. No. 98-861 (June 23, 1984), p. 1258 (Conference Report).

Revenue Effect

This provision will have a negligible effect on fiscal year budget receipts.

F. Miscellaneous Housing Provisions

1. Disaster Loss Deduction When Taxpayer Ordered to Demolish or Relocate Residence in Disaster Area Because of Disaster (sec. 1051 of the Act and sec. 165(k) of the Code)[45]

Prior Law

Deduction for casualty and theft losses

The Internal Revenue Code generally does not allow a deduction for nonbusiness losses. However, taxpayers are allowed a deduction for losses not connected with a trade or business if such losses arise from fire, storm, shipwreck, or other casualty, or from theft (sec. 165(c)(3)). The amount which may be deducted for such a nonbusiness casualty loss equals the lesser of (1) the difference between the fair market value of the property immediately before the casualty and the fair market value of the property immediately after the casualty, or (2) the taxpayer's adjusted basis for the property (Treas. Reg. sec. 1.165-7(b)). The deduction for nonbusiness losses is allowed only to the extent that the amount of loss from any individual occurrence exceeds $100. Additionally, the deduction is allowed only to the extent that the total amount of casualty and theft losses sustained during the taxable year exceeds 10 percent of the taxpayer's adjusted gross income (sec. 165(h)).

Requirement of physical damage

Under prior law, the courts and the Internal Revenue Service generally allowed a deduction for nonbusiness casualty losses only where the casualty (e.g. storm, flood, or earthquake) caused actual physical damage to the taxpayer's property. A decline in value of property as a result of dangerous conditions, rather than as a result of physical damage, was generally held not to be a deductible casualty loss.

For example, in one case,[46] the United States Court of Appeals for the Ninth Circuit held that taxpayers were not entitled to a deduction for a casualty loss on the sale of their property following a nearby mudslide. The Court held that the decline in value of the property did not result from damage caused by the mudslide itself, but from buyers' predictions of damage from future casualties.

Timing of deduction

Casualty losses generally are deductible in the year in which the casualty is sustained.

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[45] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 803; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1709-1712; and H. Rep. No. 98-861 (June 23, 1984), p. 1264 (Conference Report).

[46] *Kamanski v. Commissioner*, 477 F.2d 452 (9th Cir. 1973), *aff'g* 29 T.C.M. 1702 (1970).

Prior and present law (sec. 165(i)) provides a special rule regarding the timing of deductions for losses attributable to a disaster occurring in an area subsequently determined by the President to warrant Federal assistance under the Disaster Relief Act of 1974.[47] Under this rule, the amount of the loss may, at the election of the taxpayer, be taken into account in determining the taxpayer's liability for the taxable year immediately preceding the year in which the disaster occurred. The election, if made, must apply to the entire loss sustained by the taxpayer.

Reasons for Change

The Congress was concerned that, in the case of certain natural disasters, casualty loss deductions had been allowed under prior law to taxpayers whose residences had been physically destroyed by the disaster, but not to taxpayers whose residences had been condemned because of a threat of further destruction or because their residences had otherwise been rendered uninhabitable by the disaster. This occurred under prior law even though, as a direct result of the disaster, both these groups of taxpayers were denied further use of their residences and were subject to immediate and substantial economic loss. The Congress concluded that these similarly situated classes of taxpayers should receive similar tax treatment. The Congress further believed that the tax laws should not act to discourage the evacuation of dangerous residences by State and local authorities. Accordingly, it concluded that a deduction should be allowed to taxpayers who are ordered to demolish or relocate their residences as a proximate result of certain disasters which have rendered the residences unsafe for use, whether or not the residences have been physically damaged.

At the same time, the Congress reaffirmed the general rule that allows nonbusiness casualty loss deductions only for sudden, unexpected losses, and denies a deduction for gradual declines in property values. The Congress was aware of the administrative difficulties and unjustified tax benefits that could result from too broad a liberalization of the casualty loss deduction rules. Because of these considerations, the Congress decided to place several strict limitations on the modifications to the casualty loss deduction made by the Act. First, the provision is limited to residences located within a Federally declared disaster area. Second, the provision applies only where the demolition or evacuation order is made by the appropriate State or local government, and within a specified period. Finally, the provision is limited to cases in which the taxpayer's residence has been rendered unsafe as a proximate result of the disaster. These requirements are designed to ensure that the casualty loss deduction allowable under the provision remains consist-

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[47] P.L. 93-288, 93d Cong., 2d Sess., May 22, 1974 (42 U.S.C. sec. 5121 et seq.). The Disaster Relief Act of 1974 empowers the President to declare an area affected by a disaster (including storms, floods, earthquakes, landslides, mudslides, hurricanes, tornadoes, fires, and explosions) either an "emergency" or a "major disaster" area. The declaration of an emergency permits the Federal government to take immediate steps to protect life, health and property, and to provide various forms of emergency assistance. Where a major disaster is declared, the Federal Government is authorized to provide various additional forms of assistance, including financial assistance (such as grants and loans) to private parties affected by the disaster.

ent with the general rules for deducting nonbusiness casualty losses.

Explanation of Provision

The Act provides that certain taxpayers whose residences are located in an area determined by the President to warrant Federal assistance under the Disaster Relief Act of 1974,[48] and who are ordered to demolish or relocate such residences, may treat any loss attributable to the disaster that caused the demolition or evacuation order as a casualty loss deductible in accordance with section 165. This rule applies if (1) the taxpayer is ordered by the State or local government in which the residence is located, not later than 120 days after the Presidential determination, to demolish or relocate the residence, and (2) the residence has been rendered unsafe for use as a residence by reason of the disaster.

It is intended under the Act that a deduction is allowable only when a residence is rendered unsafe as a proximate result of the disaster (including, but not limited to, storms, floods, fires, earthquakes, mudslides, earthslides, hurricanes, lightning, and tornadoes). That is, the residence must be rendered materially more dangerous after the disaster than it was before the disaster, and the danger must be from a materially increased risk of future destruction arising from the disaster. For example, in a storm disaster area, loss from a demolition or relocation order based on a finding that a residence was rendered unsafe by nearby mudslides would be treated as a casualty loss under the provision. By contrast, any decline in the value of a residence resulting from pre-existing dangerous conditions (e.g., by reason of location in an historically storm-prone region) does not constitute a casualty loss, even if the house is condemned.

The amount of deduction allowed for any loss treated as a casualty loss under the Act is to be determined under the general rules applicable to nonbusiness casualty losses. Thus, the amount deductible equals the lesser of (1) the difference between the fair market value of the property immediately before the disaster and the fair market value of the property immediately after the disaster, or (2) the taxpayer's adjusted basis for the property. The amount of the deduction would be reduced by any insurance or other compensation received with respect to the property, including any amount realized upon a condemnation sale.

In the case of a relocated residence, fair market value immediately after the disaster is to be determined based on the value of the residence prior to relocation. For example, if a residence has a fair market value of $100,000 immediately before a disaster, and a fair market value of $20,000 immediately after the disaster, the taxpayer would realize a loss of $80,000 (or, if less, an amount equal to the adjusted basis of the residence), regardless of the value of the residence in any new location.

As under prior law, the component of loss in value because of any general market decline affecting undamaged as well as dam-

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[48] See note 47, *supra*.

aged property is not deductible, even where the decline in value of the undamaged property occurs simultaneously with the disaster.

Amounts deductible under this provision of the Act are subject to the timing provisions of prior and present law for disaster losses. Thus, at the taxpayer's election, these amounts may be deducted on the taxpayer's return for the taxable year immediately preceding the year in which the order to demolish or relocate the residence was made.

Effective Date

The provision applies to taxable years beginning after December 31, 1981, with respect to areas determined after that date to warrant Federal disaster assistance.

Revenue Effect

This provision is estimated to reduce fiscal year budget receipts by $15 million in 1984, $12 million in 1985, $12 million in 1986, $13 million in 1987, $13 million in 1988, and $14 million in 1989.

2. Deductibility of Mortgage Interest and Taxes Allocable to Tax-Free Allowances for Ministers (sec. 1052 of the Act and sec. 265(1) of the Code) [49]

Prior Law

Code section 265(1) disallows deductions for expenses allocable to tax-exempt income. That provision has most frequently been applied to disallow a deduction for expenses incurred in the production of tax-exempt income (e.g., expenses incurred in earning income on tax-exempt investments). However, the provision has also been applied in certain cases where the use of tax-exempt income is sufficiently related to the generation of a deduction to warrant disallowance of that deduction. For example, section 265(1) has been held to disallow a deduction for that portion of a veteran's flight-training expenses which were reimbursed by the Veterans Administration under a tax-free educational allowance program.[50]

In January, 1983, the Internal Revenue Service ruled that section 265(1) precludes a minister from taking deductions for mortgage interest and real estate taxes on a residence to the extent that such expenditures are allocable to a tax-free housing allowance[51] received by the minister (Rev. Rul. 83-3, 1983-1 C.B. 72). This ruling revoked a 1962 ruling which had taken a contrary position. In its 1983 ruling, the Revenue Service stated that where a taxpayer incurs expenses for purposes for which tax-exempt income was received, permitting a full deduction for such expenses would lead to a double benefit not allowed under section 265(1) as interpreted by the courts.

The 1983 ruling generally was made applicable beginning July 1, 1983. However, for a minister who owned and occupied a home before January 3, 1983 (or had a contract to purchase a home before that date), the deduction disallowance rule was delayed by the Internal Revenue Service until January 1, 1985, with respect to such home (IRS Ann. 83-100).

Reasons for Change

In general, the tax rules that are designed to disallow "double benefits" are necessary to reflect a taxpayer's true economic status. One such principle operates to prevent the deduction of an amount

[49] For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 870; S. Prt. 98-169, Vol. I (April 2, 1984), p. 869; Senate floor amendment, 130 Cong. Rec. S. 4337 (April 11, 1984); and H. Rep. No. 98-861 (June 23, 1984), p. 1268 (Conference Report).

[50] *Manocchio* v. *Comm'r*, 78 T.C. 989 (1982), *aff'd* 710 F.2d 1400 (9th Cir. 1983).

[51] Code section 107 provides that gross income does not include (1) the rental value of a home furnished to a minister as part of compensation, or (2) the rental allowance paid to a minister as part of compensation, to the extent the allowance is used to rent or provide a home.

attributable to funds previously excluded from gross income; otherwise, expenditures in effect made out of tax-free income could be used to generate deductions to offset taxable income. The Internal Revenue Service, in its 1983 ruling, applied this principle to disallow deductions for mortgage interest and real estate taxes to the extent allocable to tax-free housing allowances for ministers.

At the same time, the Congress believed that the effective date of Revenue Ruling 83-3 should be delayed for one additional year (through December 31, 1985) in the case of ministers who purchased their homes prior to January 3, 1983. These ministers, who had purchased their homes prior to that date, may have relied on the pre-1983 position of the Revenue Service in purchasing their homes. Accordingly, in such circumstances, the Congress believed that it is appropriate to provide an additional year of transitional relief to allow these ministers to seek additional compensation from their employers or make other adjustments to neutralize the effect of the disallowance of the double tax benefits.

Explanation of Provision

The Act extends through December 31, 1985 the transitional rule effective date of Revenue Ruling 83-3 applicable to certain ministers in the circumstances defined in IRS Ann. 83-100, i.e., to a minister who owned and occupied a home before January 3, 1983 (or had a contract to purchase a home before that date). In the case of mortgage interest deductions, the provision in the Act only applies to a mortgage existing on that date (or in connection with a contract to purchase a home before that date).

In the case of ministers who do not qualify for the extended transitional rule effective date as provided by the Act, no change is made in the general effective date (July 1, 1983) stated in Rev. Rul. 83-3 for application of the rules set forth in that ruling.

Effective Date

The provision is effective on the date of enactment (July 18, 1984).

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by less than $5 million in each of 1985 and 1986.

3. Rollover of Gain on Sale of Residence of Military Personnel Stationed Overseas or at Certain Remote Sites (sec. 1053 of the Act and sec. 1034(h) of the Code)[52]

Prior Law

No gain is recognized on sale of a personal residence to the extent that the amount of the sales price of the old residence is reinvested in a new residence within a specified period of time, generally ending two years after the sale of the old residence. This period is extended for up to four years where the taxpayer serves on extended active duty with the Armed Forces (Code sec. 1034(h)). Prior law did not provide for a longer nonrecognition rollover period in the case of military personnel stationed overseas or required to reside in government quarters at remote sites.

Reasons for Change

The Congress believed that in the case of military personnel stationed outside the United States, or required to reside in government quarters at certain remote sites, a longer nonrecognition rollover period (not to exceed eight years after the date of the sale of the old residence) is needed in such circumstances to provide sufficient time for reinvestment of proceeds from sale of the old residence in a new residence.

Explanation of Provision

The Act provides an extended nonrecognition period in the case of a person serving on extended active duty with the U.S. Armed Forces who (during the nonrecognition period described in sec. 1034(h)(1)) either (1) is stationed outside the United States or (2) is required, after returning from a tour of duty outside of the United States and pursuant to a determination by the Secretary of Defense that adequate off-base housing is not available at a remote base site, to reside in on-base government-owned quarters. In such a case, the nonrecognition rollover period otherwise allowable under section 1034(h)(1) is not to expire until the last day on which such person is stationed outside the United States or is required to reside in government quarters at a remote base site, as the case may be, except that this nonrecognition period cannot exceed eight years after the date of the sale of the old residence.

Effective Date

This provision applies to sales of old residences (within the meaning of sec. 1034) after the date of enactment (July 18, 1984).

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[52] For legislative background of the provision, see: Senate floor amendment, 130 Cong. Rec. S. 4536 (April 12, 1984); and H. Rep. No. 98-861 (June 23, 1984), p. 1269 (Conference Report).

Revenue Effect

The provision is estimated to reduce budget receipts by a negligible amount in fiscal year 1984 and by $5 million annually thereafter.

4. Nonimposition of Interest and Penalties on Tax Liability With Respect to Home Won in Contest and Specially Designed for Taxpayer's Handicapped Foster Child (sec. 1054 of the Act)[53]

Prior Law

Under prior and present law, gross income generally includes amounts received as prizes, such as cash or property won in a lottery, sweepstakes, or other contest (Code sec. 74(a)).

Reasons for Change

The Congress was informed of a situation in which the mother of a handicapped foster child won a $75,000 house in a contest involving more than one million entries. The developer custom-built the house to meet the needs of the 13-year-old boy, who has had kidney and heart surgery and is paralyzed. The taxpayer was unable to obtain a mortgage on the house to timely pay the entire Federal income tax liability due with respect to inclusion of the fair market value of the house in her gross income, because of her low salary as a school computer operator, and was unable to work out a schedule for installment payment of the tax liability which was acceptable to the Internal Revenue Service. As a result, a lien had been placed on the house, which might have resulted in a forced sale.

The Congress also was informed that a citizen had offered, as an act of private benevolence, to pay the Federal tax liability resulting from inclusion of the house in gross income, but not any interest or penalties imposed for prior nonpayment of that liability (understood to amount to about $20,000). Under these unique circumstances, the Congress believed that it would not be appropriate to impose interest and penalties with respect to the tax liability to be paid by the benevolent citizen, so that the handicapped child may continue to live in the house which was specially designed to meet his needs.

Explanation of Provision

Under the provision, no interest, penalty, or other addition to tax is payable on the amount of Federal income tax liability (which is to be computed without regard to such additional amounts) attributable to receipt of a residence won as a prize, where certain conditions apply, but only if such Federal income tax liability (as so computed) is paid not later than one year after the date of enactment of the provision (July 18, 1984). The provision only applies to a resi-

[53] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 809; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1742-43; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 871; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 867-68; and H. Rep. No. 98-861 (June 23, 1984), p. 1269 (Conference Report).

dence which (1) was won by the taxpayer in a local radio contest; (2) was specially designed to meet the needs of a handicapped foster child of the taxpayer; (3) is the principal residence (within the meaning of sec. 1034) of the taxpayer; and (4) had a lien placed on it by the Internal Revenue Service on May 24, 1983, after an Internal Revenue Service supervisor had overruled two payment schedules negotiated with the taxpayer for the payment of taxes, interest, and penalties on income attributable to such residence for the taxpayer's 1980 taxable year.

Effective Date

The provision is effective on enactment (July 18, 1984).

Revenue Effect

The provision is estimated to have a negligible effect on budget receipts.

G. Extension of Existing Provisions and Transition Rules

1. Extension of the Special Tax Rules for the Payment-in-Kind Program (sec. 1061 of the Act and P.L. 98-4)[54]

Prior Law

PIK Tax Treatment Act

The Payment-in-Kind Tax Treatment Act of 1983[55] generally treated commodities received under a 1983 PIK program as if they were grown on the land withdrawn from production under the PIK program. The Act thereby permitted continued availability to participants in the PIK program of numerous Code provisions available only to persons engaged in active farming operations. The Act also provided that estates are not disqualified from certain special estate tax provisions that are available only to owners of active farming operations solely by reason of participation in a PIK program.

Overview of PIK program

The Department of Agriculture ("USDA") announced a 1984 Payment-in-Kind program on August 9, 1983. The 1984 PIK program was a program for diverting from production land which otherwise would be used to produce wheat. Under the program, producers were provided a quantity of wheat as compensation for diverting acreage normally planted in that crop. USDA conducted similar programs during the 1983 crop year for wheat, corn, grain sorghum, rice, and upland cotton.

The law limits to $50,000 the amount of payments USDA may make to a producer under crop acreage reduction programs. When the PIK programs were first announced in January 1983, USDA announced that the $50,000 limit applied only to cash payments, and not to payments-in-kind. On November 1, 1983, the General Accounting Office issued a determination that the $50,000 limit applies to payments under all acreage reduction programs, whether the payments are made in cash or in kind. The $50,000 limit was applied to payments under the 1984 wheat PIK program.

Reasons for Change

Congress believed that farmers should not be discouraged from participating in the 1984 PIK program solely because of potentially

[54] For legislative background of the provision see: H.R. 4170, committee amendment approved by the House Committee on Ways & Means on March 1, 1984, sec. 806; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), p. 1723; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 864; S. Prt. 98-169, Vol. I (April 2, 1984), p. 833; Senate floor amendment, 130 Cong. Rec. S. 4505 (April 12, 1984); and H. Rep. No. 98-861 (June 23, 1984), p. 1271 (Conference Report).

[55] P.L. 98-4 (March 11, 1983).

adverse income and estate tax consequences. Congress was disturbed, however, over the extremely large payments received by some farmers under the 1983 PIK program. These large payments were especially disturbing in light of the General Accounting Office's determination on November 1, 1983, that payments under the USDA acreage reduction programs in excess of $50,000 per farmer were not authorized under the applicable Federal agriculture statutes. Because USDA applied the $50,000 limit generally applicable to crop diversion payments to 1984 PIK payments, however, Congress believed extension of the special 1983 PIK tax rules was appropriate.

Explanation of Provision

The Act extends the 1983 PIK tax provisions to property withdrawn from production under the 1984 PIK program for wheat.

Effective Date

The income tax provisions of section 1061 of the Act apply to wheat payments received in the 1984 PIK program; the estate tax provisions apply to land withdrawn from production in that program.

Revenue Effect

This provision is estimated to reduce budget receipts by $7 million in fiscal year 1984 and $8 million in fiscal year 1985. Budget receipts will increase by $15 million in fiscal year 1986 as a result of the provision.

2. Reinstatement of Deduction for Elimination of Certain Barriers to the Handicapped and the Elderly (sec. 1062 of the Act and sec. 190 of the Code)[56]

Prior Law

Under prior law, Code section 190 provided a special tax deduction for up to $25,000 of expenses incurred during a taxable year in removing architectural or transportation barriers to the handicapped and the elderly. This provision was effective for taxable years beginning before 1983. Thus, for taxable years beginning after 1982, no special deduction for such expenses was provided.

Section 190 applied to expenses incurred to make facilities, or transportation vehicles owned or leased by the taxpayer for use in the taxpayer's trade or business, more accessible to, and usable by, the handicapped and elderly. To be entitled to the deduction, the taxpayer had to establish that the barrier removal met standards set by the Treasury with the concurrence of the Architectural and Transportation Barriers Compliance Board. Under section 190, the definition of an elderly person was a person age 65 or over, and handicapped individuals included the blind and the deaf.

The maximum deduction allowed under prior law to a taxpayer (including a controlled group of corporations filing a consolidated return) for any taxable year was $25,000.

Reasons for Change

The Congress believed that it is desirable to encourage the removal of architectural and transportation barriers to the handicapped and the elderly through reinstating the deduction for certain expenses incurred in the removal of such barriers, and increasing the maximum deduction to $35,000.

Explanation of Provision

Under the Act, section 190 of the Code is reinstated and made applicable to expenses incurred in taxable years beginning after December 31, 1983, and before January 1, 1986. (Thus, the special deduction provided by section 190 does not apply to expenses incurred in taxable years beginning in 1983.) The maximum deduction allowed to a taxpayer (including a controlled group of corporations) is increased to $35,000.

[56]For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 880; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 895-96; and H. Rep. No. 98-861 (June 23, 1984), pp. 1274-75 (Conference Report).

Effective Date

The provision is effective on the date of enactment (July 18, 1984). As reinstated, Code section 190 applies to expenses incurred in taxable years beginning after December 31, 1983, and before January 1, 1986.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by $8 million in 1984, $16 million in 1985, and $7 million in 1986.

3. Disallowance of Deduction for Costs of Demolishing Structures (sec. 1063 of the Act and sec. 280B of the Code) [56]

Prior Law

Under prior law, costs and other losses incurred in connection with the demolition of buildings generally could be claimed as a current deduction unless the building and the property on which it was located were purchased with an intent to demolish the building. If so purchased, costs and other losses associated with demolition were added to the basis of the land.

Before 1984, costs and other losses incurred in connection with the demolition of certified historic structures were required to be added to the basis of the land on which the structure was located in all cases. A certified historic structure is a building that is certified by the Secretary of the Interior as having historic significance and that meets certain other requirements.

Reasons for Change

Congress believed that preservation of certified historic structures is an important national objective. Accordingly, Congress determined that the pre-1984 rules relating to the demolition of certified historic structures should be made permanent.

In addition, Congress believed that capitalization of demolition costs of buildings that are not certified historic structures where the intent to demolish did not exist at the time of acquisition is more appropriate than deducting these costs, in that these costs are more in the nature of capital costs than current expenses. Moreover, Congress viewed reliance on the subjective intent of the taxpayer as presenting significant enforcement problems. These enforcement problems became even more significant if a period of time passed between acquisition and demolition.

Finally, the provision reflects a concern that prior law may have operated as an undue incentive for the demolition of existing structures that were not certified historic structures. Such an incentive would be inconsistent with the Code rules pursuant to which substantial tax credits are available for rehabilitation of these buildings if the buildings are over 30 years old.

Explanation of Provision

The Act provides a general rule under which costs and other losses incurred in connection with the demolition of all buildings, including certified historic structures, must be added to the basis of

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[56] For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 879; S. Prt. 98-169, Vol. I (April 2, 1984), p. 893; Senate floor amendment, 130 Cong. Rec. S. 4122 (April 9, 1984); and H. Rep. No. 98-861 (June 23, 1984), p. 1273 (Conference Report).

the land on which the demolished buildings were located, rather than claimed as a current deduction.

Effective Date

The provision is effective for taxable years beginning after December 31, 1983.[57]

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by less than $5 million annually.

[57] It is anticipated that a technical amendment will be recommended that would defer the effective date of the provision with respect to structures that are not certified historic structures to demolitions commencing after July 18, 1984.

4. Amortization of Low-Income Housing Expenditures (sec. 1064 of the Act and sec. 167(k) of the Code)[58]

Prior Law

Prior law provided that a taxpayer could elect (in lieu of any other cost recovery method) to amortize generally up to $20,000 of rehabilitation expenditures with respect to a unit of low-income housing over a 60-month period (Code sec. 167(k)). This provision expired on January 1, 1984.

Reasons for Change

Congress believed that special tax incentives continue to be needed to ensure that affordable housing is available to individuals of limited means. Therefore, Congress determined that the special 60-month amortization provision of prior law should be reinstated. At the same time, because Congress believed generally that special tax incentives such as this amortization provision should be the subject of ongoing review as economic conditions change, the provision was reenacted for three years only, through December 31, 1986.

Explanation of Provision

The Act reinstates the provision of prior law that permitted amortization over a 60-month period of certain expenditures for rehabilitation of low-income housing.

Effective Date

This provision of the Act generally is effective with respect to rehabilitation expenditures incurred after December 31, 1983, and before January 1, 1987.

Under an extension of the affirmative commitment rule included in the prior-law provision (Code sec. 167(k)(3)(D)), the reenacted provision also applies to rehabilitation expenditures incurred after December 31, 1986, that are incurred pursuant to a binding contract entered into before January 1, 1987, if the contract is binding at all times on and after that date, and to rehabilitation expenditures incurred with respect to low-income rental housing, the rehabilitation of which begins before January 1, 1987.

Whether or not an arrangement constitutes a contract is to be determined under the applicable local law. A binding contract is not considered to exist before January 1, 1987, however, unless the

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[58] For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 878; S. Prt. 98-169, Vol. I (April 2, 1984), p. 891; and H. Rep. No. 98-861 (June 23, 1984), p. 1273 (Conference Report).

property to be acquired or the services to be rendered are identified or described specifically before that date.

A binding contract for purposes of this provision exists only with respect to property or services for which the taxpayer is obligated to pay under the contract. In addition, where a contract obligates a taxpayer to purchase a specified number of items or services and also grants him an option to purchase additional items, the contract is binding on the taxpayer only to the extent of the items or services that must be purchased.

A contract may be considered binding on the taxpayer even though (1) the price of the item to be acquired or the services to be rendered under the contract is to be determined at a later date, (2) the contract contains conditions the occurrence of which are under the control of a person not a party to the contract, or (3) the taxpayer has the right under the contract to make minor modifications as to the details of the subject matter of the contract.

On the other hand, a contract that is binding on a taxpayer before January 1, 1987, will not be considered binding at all times on and after that date if it is modified substantially after that date. Additionally, a contract under which the taxpayer has an option to acquire property is not a contract that is binding on the taxpayer for purposes of this exception unless the amount paid for the option is forfeitable and is more than a nominal amount.

Under the affirmative commitment rule, a rehabilitation is considered to have begun before January 1, 1987, only if actual physical work on the rehabilitation is begun before that date and only if the physical work that is begun before January 1, 1987, is significant when viewed in light of the entire rehabilitation project.

Revenue Effect

This provision is estimated to reduce fiscal year budget receipts by $2 million in 1984, $7 million in 1985, $18 million in 1986, $32 million in 1987, $43 million in 1988, and $34 million in 1989.

5. Provisions of Indian Tribal Governmental Tax Status Act of 1982 Made Permanent (sec. 1065 of the Act, sec. 7871 of the Code, and sec. 208 of the Periodic Payments Tax Act of 1982)[59]

Prior Law

Prior law provided that, for years 1983 and 1984 only, Indian tribal governments were treated as State governments for most purposes of the Internal Revenue Code.

Special restrictions applied to this treatment in certain cases. For example, Indian tribal governments were permitted to issue tax-exempt bonds only to finance essential governmental functions (e.g., schools, streets, and sewers). Tribal governments were not permitted, therefore, to issue private activity bonds (i.e., industrial development bonds, student loan bonds, and mortgage subsidy bonds). Additionally, exemptions from Federal excise taxes provided for State governments applied to articles sold to the Indian tribal governments only if the articles were sold for the tribal government's exclusive use in carrying out an essential governmental function.

Reasons for Change

Congress believed that the provisions pursuant to which tribal governments are treated as State governments for tax purposes should be made permanent, because Indian tribal governments perform many of the functions of State governments. Except in limited circumstances, however, Congress did not believe that these provisions should be expanded to permit tribal governments additional tax benefits (e.g., authority to issue private activity bonds) absent a thorough examination of how any such expansion should be integrated with other provisions of the Act (e.g., the new restrictions on industrial development bonds).

Explanation of Provisions

The Act makes permanent the prior-law provisions treating Indian tribal governments as State governments.

The Act also permits Indian tribal governments to be treated as State governments for the following purposes in addition to the purposes for which such treatment was available under prior law:

(1) Treatment of amounts received from a sickness or disability fund for State employees;

(2) Deductibility of expenses incurred in direct connection with appearances before or communications with State legislatures; and

[59] For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 877; S. Prt. 98-169, Vol. I (April 2, 1984), p. 889; and H. Rep. No. 98-861 (June 23, 1984), p. 1272 (Conference Report).

(3) Rules providing that original issue discount on short-term State obligations is not considered to accrue until the obligation is paid, sold, or otherwise disposed of.

Effective Date

The provisions that were scheduled to expire at the end of 1984 are made permanent, effective as if originally enacted as permanent provisions.

The new provisions of the Act are effective for taxable years beginning after December 31, 1984.

Revenue Effect

This provision is estimated to reduce fiscal year budget receipts by less than $5 million annually.

6. Investment Income from S Corporations (sec. 1066 of the Act and sec. 163(d) of the Code)[60]

Prior Law

Under prior law, an individual's deduction for investment interest was generally limited to net investment income plus $10,000 (sec. 163(d)). Investment income included dividends, interest, rents, and royalties. Under the provisions of subchapter S in effect prior to the Subchapter S Revision Act of 1982, one court held that income from a subchapter S corporation qualified as investment income.[61] The 1982 Act provided that the character of subchapter S income flows through to the shareholders, and therefore S corporation business income would not be treated as investment income.

Reasons for Change

If, under prior law, income for subchapter S corporations was properly characterized as investment income, then the changes in the Subchapter S Revision Act could have an adverse impact to certain shareholders of these corporations.

In order to lessen this potential impact, the Congress believed it is appropriate to allow shareholders of S corporations an additional two years to treat the S corporation income, for purposes of the investment income rules, under the law previously in effect.

Explanation of Provision

The Act provides that a shareholder may elect to characterize income of a corporation with a subchapter S election in effect for its last taxable year beginning before 1983 under the law in effect prior to the enactment of the Subchapter S Revision Act of 1982, for purposes of section 163(d).

No inference is intended as to the proper interpretation of whether income from S corporations was characterized as investment income under prior law.

Effective Date

The provision is effective for taxable years beginning in 1983 and 1984.

Revenue Effect

The provision will decrease revenues by a negligible amount.

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[60] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 810; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), p. 1755; and H. Rep. No. 98-861 (June 23, 1984), pp. 1270-1271 (Conference Report).

[61] *William H. Crook*, 80 T.C. 27 (1983), appeal pending.

7. Special Leasing Rules for Certain Coal Gasification Facilities (sec. 1067 of the Act and sec. 280(d) of the Tax Equity and Fiscal Responsibility Act of 1982)[62]

Prior Law

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) generally reduced the tax benefits of safe-harbor leasing for agreements entered into between July 1, 1982, and January 1, 1984, and repealed safe-harbor leasing for agreements entered into after December 31, 1983. However, these modifications do not apply to transitional safe-harbor lease property, which generally is property placed in service before January 1, 1983, provided that certain additional requirements are met.

Reasons for Change

Congress believed that the long construction period associated with certain coal gasification facilities should be taken into account in determining equitable safe-harbor leasing transition rules.

Explanation of Provision

Under the Act, transitional safe-harbor lease property includes a coal gasification facility that would meet the requirements of the general transitional rule in TEFRA if (1) July 1, 1984, were substituted for the January 1, 1983, placed-in-service date, (2) the facility is treated as placed in service when the taxpayer receives an operating permit for it from a State environmental protection agency, and (3) the facility is treated as acquired after December 31, 1980, and before July 2, 1982, if at least 20 percent of the facility's cost was paid during that period. The provision is limited to the 5-year lease of an undivided interest in the facility in an amount which does not exceed the lesser of $67.5 million or 50 percent of the cost basis of the entire facility. The percentage of basis which is leased under this provision is used to determine the amount of any recapture of investment tax credits allowed for progress expenditures on the entire facility.

Congress intended that a coal gasification facility to which this provision applies may be leased under a safe-harbor lease within three months after it is placed in service by the lessee, without losing its status as transitional safe-harbor lease property.

Effective Date

The provision takes effect as if included in TEFRA.

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[62] For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 875; S Prt 98-169, Vol I (April 2, 1984), p. 888; and H. Rep. No. 98-861 (June 23, 1984), p. 1272 (Conference Report)

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by $8 million in 1985, $2 million in 1986, and $1 million in both 1987 and 1988.

H. Additional Provisions

1. Tax treatment of Regulated Investment Companies (sec. 1071 of the Act and secs. 851-852 of the Code)[63]

Prior Law

Regulated investment companies

A regulated investment company (RIC) is treated, in essence, as a conduit for tax purposes. If a corporation qualifies as a RIC, it is allowed a deduction for dividends paid (or deemed paid) to its shareholders. Thus, no corporate level tax is payable on earnings of a RIC distributed (or deemed distributed) to its shareholders.

In order for a corporation to qualify as a RIC, it must meet several requirements. First, it must be a domestic corporation which (1) at all times during the taxable year is registered under the Investment Company Act of 1940, as amended, as a management company or as a unit investment trust, or (2) which is a common trust fund or similar fund which meets certain requirements.[64] Second, the corporation must elect RIC status for the taxable year (or must have made such an election for a previous taxable year). Third, the corporation must meet certain gross income and investment requirements.[65] Fourth, the corporation must meet certain distribution requirements.[66]

Under prior law, a personal holding company (PHC) could not qualify as a RIC. With certain exceptions, a PHC is any corporation if (1) at least 60 percent of its adjusted gross income consists of dividends, interest, rents, royalties, or other types of passive income, and (2) at any time during the last half of the taxable year, more than 50 percent of the value of its outstanding stock is owned (di-

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[63] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 810; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), p. 1744; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 861; S. Prt. 98-169, Vol. I (April 2, 1984), p. 824; and H Rep. No. 98-861 (June 23, 1984), p. 1744 (Conference Report).

[64] These requirements are that the corporation be a common trust fund or similar fund excluded by section 3(c)(3) of the Investment Company Act of 1940 from the definition of "investment company," and not be included in the definition of common trust fund under Code section 584(a).

[65] In general, at least 90 percent of the corporation's gross income must be derived from dividends, interest, certain payments with respect to securities loans, and gains from the sale or other disposition of stock or securities. In addition, less than 30 percent of its gross income can be derived form the sale or other disposition of stock or securities held for less than three months. At the close of any quarter, at least 50 percent of its total assets must be represented by cash, cash items, government securities, securities of other RICs, and certain other securities. Not more than 25 percent of the value of the total assets of the corporation can be invested in securities (other than government securities or securities of other RICs) of any one issuer, or of two or more issuers controlled by the taxpayer and determined to be engaged in the same, a similar, or a related trade or business.

[66] A RIC must distribute at least 90 percent of its investment company taxable income for the taxable year (determined, in general, without regard to the dividends paid deduction), and 90 percent of the amount of its tax exempt interest income over the deductions allocable to such income (and disallowed as deductions for that reason).

rectly or indirectly) by or for five or fewer individuals. Personal holding companies are generally subject to a special 50 percent tax on any undistributed personal holding company income.

Accounting for short-term government obligations

In the case of any short-term obligation of the United States, a state, or any possession of the United States, or any political subdivision of the foregoing, or the District of Columbia, issued at a discount and redeemable at maturity without interest, the amount of the issue discount was deemed to accrue at the earlier of the date the obligation was paid at maturity or the date the obligation was sold or otherwise disposed of. For this purpose, an obligation was treated as a short-term obligation if it had a fixed maturity date not exceeding one year from the date of issue. Thus, with respect to such obligations, accrual basis taxpayers were not taxable on the discount until the obligation matured.

Reasons for Change

Under the Subchapter S Revision Act of 1982, a PHC can elect S corporation status and thereby have its income taxed directly to the shareholders without being subject to a corporate level tax. The Congress believed that if a PHC is qualified to elect S corporation status, it should also be qualified to elect RIC status.

Under the new rules, a corporation with undistributed earnings and profits accumulated during a non-RIC year cannot qualify as a RIC. The Congress was concerned that if an operating company that accumulated earnings and profits as a regular corporation could sell its operating assets, invest in passive investment assets, and then elect RIC status, such earnings and profits would not be subject to a shareholder level tax. The Congress believed that earnings and profits accumulated while the corporation was a regular corporation should be taxed at both the corporate and the shareholder levels.

The Congress also believed that a RIC should be able to account for issue discount on short-term government obligations on the accrual basis. This method is consistent with the method used by RICs in accounting for, and computing distributions to, shareholders.

Explanation of Provisions

Regulated investment companies

The Act repeals the prohibition of prior law which denied eligibility for RIC status to a PHC. Further, the Act provides that the undistributed investment company taxable income of any RIC which is a PHC will be subject to tax at the highest rate applicable to corporations.

Under the Act, a corporation cannot qualify as a RIC for any taxable year unless (1) the RIC provisions applied to the company for all taxable years ending on or after November 8, 1983, or (2) at the close of the taxable year, the company has no earnings and profits attributable to any taxable year during which it was not a RIC. Thus, a corporation that was not a RIC during the taxable year that ended on or after November 8, 1983, cannot elect RIC status without distributing any earnings and profits attributable to a non-RIC year.

Rules are provided to allow a company to be eligible to be treated as a RIC for any taxable year subsequent to a taxable year with respect to which it is determined that the RIC qualification requirements were not met. Under these rules, a corporation may requalify as a RIC if, within 90 days after a determination[67] is made, the corporation distributes property in an amount equal to the accumulated earnings and profits (as of the determination date) attributable to the non-RIC year,[68] less any interest charge. The distribution must be designated as being taken into account for the disqualified year and is not deductible in computing the taxable income of the company. The interest charge is computed for the period from the filing date for the disqualified year to the determination date on an amount equal to 50 percent, (i.e., the highest rate of tax applicable to individuals) of the earnings and profits for the non-RIC year. The period of limitation on assessment and collection of the interest is determined as if the interest arose from a tax imposed in the year the determination is made. These procedures do not apply in the case of fraud.

Accounting for short-term government obligation

Under another provision of the Act, RICs are required to currently accrue discount on all short-term obligations acquired after the date of enactment. Further, for taxable years beginning after December 31, 1978, and ending prior to the taxable year that includes the effective date for the provision requiring current accrual, a RIC can elect to accrue currently discount with respect to short-term government obligations.

Effective Dates

The new RIC qualification rules apply to taxable years beginning after December 31, 1982. In the case of any corporation which was a RIC for any taxable year ending before November 8, 1983, earnings and profits from all taxable years ending before that date shall be disregarded in applying the new requirements. Also, in the case of any corporation beginning business in 1983, earnings and profits from that initial year shall be disregarded in applying the new requirements.

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[67] The term "determination includes a final court decision, a closing agreement, a determination by the investment company filed with the Internal Revenue Service, or other agreement between the Internal Revenue Service and the company. It is expected that the Internal Revenue Service will establish a procedure to determine the amount of the company's earnings and profits attributable to non-RIC years by the time of the determination date and to extend the 90-day period if the company and the Internal Revenue Service cannot agree on such earnings and profits until such time as there is a resolution of that amount by agreement among the parties or by a final court decision. Moreover, where a company determines that it did not qualify as a RIC for a year and determines its tax liability and distributes its earnings and profits accordingly, but it is later determined that the company had additional earnings and profits for the non RIC year, it is expected that the Internal Revenue Service will make a determination in order that these subsequently determined earnings and profits may be timely distributed.

[68] The accumulated earnings and profits from a non-RIC year is the earnings and profits from the non-RIC years reduced by a deficit in earnings and profits subsequent to the non-RIC year and before the determination date.

Under a transitional rule, a corporation with earnings attributable to a non-RIC year is eligible to elect RIC status without distributing such earnings if it completed all the economic steps required to elect RIC status during the period beginning on January 1, 1982, and ending on November 7, 1983, and it has elected RIC status for its first taxable year beginning after November 8, 1983.

The election to accrue discount currently applies with respect to taxable years beginning after December 31, 1978. Mandatory accrual is required for obligations acquired after the date of enactment of the Act.

Revenue Effect

The provisions are estimated to have a negligible effect on budget receipts.

2. Employee Tips (sec. 1072 of the Act and sec. 6053 of the Code)[69]

Prior Law

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) imposed reporting rules that, under certain circumstances, require an informational report of an allocation of tips in large food or beverage establishments (defined generally to include those establishments that normally employ more than 10 employees).

Under this prior and present law, if tipped employees of large food or beverage establishments report tips aggregating 8 percent or more of the gross receipts of the establishment, then no reporting of a tip allocation is required. However, if this 8-percent reporting threshold is not met, the employer must allocate (as tips for information reporting purposes only) an amount equal to the difference between 8 percent of gross receipts and the aggregate amount reported by employees. This allocation may be made pursuant to an agreement between the employer and employees or, in the absence of such an agreement, according to Treasury regulations. Under prior law, the Secretary had the authority to reduce the 8-percent threshold down to 5 percent upon petition by the employer.

Under pre-TEFRA law, which remains in effect, tipped employees are required to maintain records that establish the amount of tip income received by them during the taxable year.

Reasons for Change

Congress believed that a majority of the employees of an establishment, in addition to the employer, should be able to petition the Secretary to reduce the percentage of gross receipts required to be allocated, and that, at least in certain instances, the minimum percentage of gross receipts required to be allocated under prior law (5 percent) may have been too high. Congress also believed that the definition of employee should not include, in the case of a corporation operating a large food or beverage establishment, individuals who own 50 percent or more of the stock of that corporation.

Explanation of Provision

The Act provides that a majority of the employees or the employer can petition the Internal Revenue Service for a reduction in the percentage of gross receipts required to be allocated. The Act also reduces the minimum percentage required to be allocated when the Internal Revenue Service agrees to a reduction from 5 to 2 percent. The Internal Revenue Service may approve a reduction to any per-

[69] For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 876; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 880-881; and H. Rep. No. 98-861 (June 23, 1984), p. 1275 (Conference Report).

centage between 8 and 2 percent. Congress anticipated that an establishment would ordinarily not be able to prove that this 2-percent rate is the appropriate rate.

The Act also provides that a person owning 50 percent or more of the value of a corporation that operates a large food or beverage establishment is not considered to be an employee of that establishment, only for purposes of determining whether the establishment normally employed more than 10 employees. The Act requires the Secretary to prescribe regulations within one year of the date of enactment that describe the applicable recordkeeping requirements for tipped employees.

Effective Date

The provisions relating to petitions by a majority of employees or the employer and to the reduction in the minimum percentage required to be allocated became effective on July 18, 1984.

The provision relating to 50-percent owners became effective beginning January 1, 1983.

The regulations are to be promulgated no later than July 18, 1985.

Revenue Effect

This provision will have a negligible effect on revenues.

3. FUTA Treatment of Tips (sec. 1073 of the Act and sec. 3306 of the Code)[70]

Prior Law

Under prior law, tip income was considered wages for purposes of the Federal Unemployment Tax Act (FUTA) only to the extent paid directly to the employee by the patron, reported by the employee to the employer, and used by the employer to satisfy the minimum wage requirement of the Fair Labor Standards Act.

Reasons for Change

Generally, State unemployment insurance laws provide unemployment insurance coverage only for employment covered by FUTA. If wages are subject to FUTA, they are generally subject to State unemployment insurance tax and can be used by the employee as qualifying wages for purposes of determining eligibility for unemployment benefits and the amount and duration of such benefits.

Under prior law, only a portion of tip income was considered wages subject to the FUTA tax. Under many State unemployment insurance laws, tip income excluded from FUTA tax cannot be used by the employee to establish eligibility for unemployment benefits. By expanding FUTA coverage to all reported tip income, Congress anticipated that State unemployment insurance laws will be amended to include all reported tip income as taxable wages and qualifying wages. Congress believed that such a change in State laws will improve unemployment insurance protection for tipped employees.

Explanation of Provision

The Act provides that all tip income reported by the employee to the employer is considered wages for FUTA purposes.

Effective Date

The provision generally is effective on January 1, 1986. However, in the case of any State the legislature of which (1) did not meet in a regular session which begins during 1984 and after the date of enactment, and (2) did not meet in a session which began before the date of enactment and remained in session for at least 25 calendar days after the date of enactment, the provision is effective on January 1, 1987.

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[70] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 811; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1748-1749; and H. Rep. No. 98-861 (June 23, 1984), pp. 1275-1276 (Conference Report).

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $18 million in 1986, $28 million in 1987, $30 million in 1988, and $32 million in 1989.

4. Extension of Exemption from FUTA for Wages of Certain Fishing Boat Crew Members (sec. 1074 of the Act and sec. 3306 of the Code)[71]

Prior Law

For purposes of social security taxes and income tax withholding, members of the crew on a boat in a fishing operation engaged in catching fish or other forms of aquatic animal life are considered to be self-employed if (1) their remuneration is a share of the boat's catch (or cash proceeds from the sale of a share of the catch and no other cash remuneration is provided), (2) their share depends on the amount of the boat's catch, and (3) the crew of the boat normally is made up of fewer than ten individuals. If these requirements are met, remuneration paid to these crew members is exempt from the Federal Insurance Contributions Act (FICA) tax and income tax withholding, and is subject to the Self-Employment Contributions Act (SECA) tax (Code secs. 3121(b)(20), 3401(a)(17), and 1402(c)(2)(F)).

Prior to the Economic Recovery Tax Act of 1981 (ERTA), remuneration paid to fishing boat crew members generally was exempt from tax under the Federal Unemployment Tax Act (FUTA), except that the exemption did not apply with respect to the services performed in connection with catching halibut or salmon for commercial purposes or services performed on a vessel of more than ten net tons (sec. 3306(c)(17)).

Section 822 of ERTA amended the definition of employment for purposes of FUTA taxes to exempt from FUTA taxes remuneration paid during 1981 to fishing boat crew members who were treated as self-employed for social security tax purposes and thus exempt from FICA (sec. 3306(c)(18)). Section 203 of the Miscellaneous Revenue Act of 1982 (P.L. 97-362) amended ERTA to provide that the exemption from FUTA taxes also was effective for remuneration paid in 1982.

Reasons for Change

The Congress believed that it was appropriate to provide an additional extension of the FUTA exemption for wages of fishing boat crew members who are treated as self-employed for purposes of social security tax and income tax withholding in order to give the Congress an opportunity to determine the best long-term solution to the problem of unemployment insurance coverage of these individuals.

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[71] For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 863; S. Prt. No. 98-169, Vol I (April 2, 1984), pp. 831-32; and H. Rep. No. 98-861 (June 23, 1984), p. 1276 (Conference Report)

Explanation of Provision

The Act amends section 822 of ERTA so that the exemption from FUTA tax for remuneration paid to fishing boat crew members who are exempt from FICA is effective for remuneration paid before January 1, 1985.

Effective Date

This provision is effective upon enactment with respect to remuneration paid in 1983 and 1984.

Revenue Effect

This provision is estimated to reduce fiscal year receipts by $1 million in 1984 and $1 million in 1985.

5. Effective Date for 1978 Revenue Act Rules on Taxation of Unemployment Compensation Benefits (sec. 1075 of the Act and sec. 112 of the Revenue Act of 1978)[72]

Prior Law

Prior to the Revenue Act of 1978, unemployment compensation paid under most government programs was excludable from gross income under a series of Internal Revenue Service rulings dating from 1938.[73] Section 112 of the Revenue Act of 1978 made includible a portion of unemployment compensation benefits paid pursuant to government programs to taxpayers who have substantial income during the year (Code sec. 85).

Under the 1978 legislation, gross income included the lesser of the amount of unemployment compensation or one-half of the excess of (1) the sum of the taxpayer's adjusted gross income, all unemployment compensation paid pursuant to government programs, and all disability income of the type eligible for exclusion from income under Code section 105(d) (since repealed), over (2) the taxpayer's base amount. The base amount generally is $12,000 for individuals and $18,000 for a joint return, except that the base amount is zero for certain married individuals who file separate returns. The Economic Recovery Tax Act of 1981 (sec. 103(c)(1)) modified the includible amount by adding to the items in (1) above the amount allowed under the deduction for two-earner married couples. (Any social security benefits otherwise included in adjusted gross income under the Social Security Amendments of 1983 are not included in adjusted gross income for purposes of determining taxable unemployment compensation.)[74]

The Revenue Act of 1978 provided that the unemployment compensation taxation provisions applied to payments of unemployment compensation made after 1978, in taxable years ending after 1978. Thus, benefits paid in 1979 and later years may have been

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[72] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 807; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1737-38; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 825; S. Prt. No. 98-169, Vol. 1 (April 2, 1984), pp. 763-64; and H. Rep. No. 98-861 (June 23, 1984), pp. 1276-77 (Conference Report).

[73] See I.T. 3230, 1938-2 C.B. 136 (payments by a State agency out of funds received from the Federal Unemployment Trust Fund); Rev. Rul. 55-652, 1955-2 C.B. 21 (unemployment compensation payments to Federal employees by State or Federal agencies); Rev. Rul. 70-280, 1970-1 C.B. 13 (payments by a State agency out of funds received from the Federal Unemployment Trust Fund); Rev. Rul. 73-154, 1973-1 C.B. 40 (unemployment compensation payments made under the Unemployment Compensation Act of 1971); Rev. Rul. 76-63, 1976-1 C.B. 14 (unemployment compensation benefits paid under the Emergency Jobs and Unemployment Assistance Act of 1974 and the Emergency Unemployment Compensation Act of 1974); Rev. Rul. 76-144, 1976-1 C.B. 17 (payments made under the Disaster Relief Act of 1974); and Rev. Rul. 76-229, 1976-1 C.B. 19 (trade readjustment allowances paid under the Trade Act of 1974).

[74] Social Security Amendments of 1983 (the Amendments), sec. 121(f)(1). The Amendments also repealed former Code sec. 105(d) and deleted the reference to Code sec. 105(d) disability income in Code sec. 85 (Amendments, secs. 122(b) and 122(c)(2)).

subject to income tax even if attributable to periods of unemployment before 1979.

Reasons for Change

The Congress believed that it was inappropriate to include in income any unemployment compensation benefits attributable to weeks of unemployment beginning before December 1, 1978, since such benefits may have been for periods of unemployment occurring well before the unemployment compensation taxation provisions were enacted.

Explanation of Provision

The Act amends the Revenue Act of 1978 to provide that the provision of that Act making includible in gross income certain amounts of unemployment compensation benefits does not apply to payments of such benefits for weeks of unemployment ending before December 1, 1978. As a result, payments of such benefits may be taxable only if made after 1978 for weeks of unemployment ending after November 30, 1978.

The Act permits taxpayers who are entitled as a result of this amendment to a credit of any overpayment or refund, but for the operation of the statute of limitations or another rule of law (including res judicata), to obtain the credit or refund by filing a claim for it before the close of the one-year period beginning on the date of enactment.

Effective Date

The provision is effective on enactment (July 18, 1984).

Revenue Effect

The provision is estimated to result in refunds or credits of less than $1 million.

6. Exclusion from Gross Income for Cancellation of Certain Student Loans (sec. 1076 of the Act and sec. 108 of the Code)[75]

Prior Law

Gross income means all income from whatever source derived, including income from discharge of indebtedness (Code sec. 61(a)(12)). However, subject to certain limitations, gross income does not include any amount received as a scholarship or a fellowship grant (sec. 117(a)). With the exception of certain Federal grants for tuition, an amount paid to an individual to enable him or her to pursue studies or research does not qualify as a scholarship or fellowship grant if the amount represents compensation for past, present, or future employment services or if the studies or research are primarily for the benefit of the grantor (Treas. Reg. sec. 1.117-4(c)).

Under certain student loan programs established by the United States, Federal instrumentalities or agencies, or State and local governments, all or a portion of the indebtedness may be forgiven if the student performs certain services for a period of time in certain geographical areas pursuant to conditions in the loan agreement. In 1973, the Internal Revenue Service ruled on a State medical education loan scholarship program under which part of the loan was forgiven if the recipient practiced medicine in a rural area of the State. The Service determined that amounts received under the program were included in the recipient's gross income to the extent that repayment of the loan was no longer required (Rev. Rul. 73-256, 1973-1 C.B. 56). The ruling stated that the required services in this case did not further an educational purpose, but were primarily designed to accomplish a basic objective of the grantor (i.e., encouraging the practice of medicine in rural areas of the State); thus, the loan cancellation was not an excludible scholarship under the Treasury regulations.

Section 2117 of the Tax Reform Act of 1976 (P.L. 94-455) provided that, in the case of loans forgiven prior to 1979, no amount was to be included in gross income by reason of the discharge of all or part of the indebtedness of an individual under certain student loan programs at educational institutions (as defined in sec. 170(b)(1)(A)(ii)). The exclusion applied where the student loan indebtedness was discharged if the individual worked for a certain period of time in certain professions in certain geographical areas or for certain classes of employers. The exclusion applied only to loans made by the United States or an instrumentality or agency thereof or by a State or local government, either directly or pursu-

[75] For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 874; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 886-887; and H. Rep. No. 98-861 (June 23, 1984), p. 1279 (Conference Report).

ant to an agreement with the educational institution. The primary purpose of the exclusion was to assist those States and cities that had experienced difficulties in attracting doctors, nurses, and teachers to serve in certain rural and low-income urban areas.

The Revenue Act of 1978 extended the exclusion for certain student loan cancellations to loans forgiven prior to January 1, 1983.

Reasons for Change

Congress believed that the exclusion for income from cancellation of certain student loans, as provided in the Tax Reform Act of 1976 and the Revenue Act of 1978, serves an important purpose in encouraging doctors, nurses, and teachers to serve in rural and low-income areas and should therefore be made permanent. At the same time, to minimize any elements of compensation in loan cancellation arrangements, Congress believed that the requirements for the exclusion should be tightened to provide that the loan cancellation could only be conditioned on the performance of services for a specified, broad class of employers (i.e., could not be conditioned on the performance of services for a specified employer or for one of a limited number of employers). Congress further believed that the exclusion should be broadened to include loans made by certain public benefit hospital corporations which are treated as public entities under applicable State law, since such organizations perform a function essentially equivalent to hospitals operated directly by State or municipal governments.

Explanation of Provision

The Act provides a permanent exclusion for income from cancellation of certain student loans similar to that provided by the Tax Reform Act of 1976 and previously extended by the Revenue Act of 1978, but with certain modifications. This exclusion is to apply where all or part of a loan is discharged if an individual works for a certain period of time in certain professions for any of a specified, broad class of employers (e.g., as a doctor for any public hospital in any rural area of the United States). A requirement that services be performed for one or a few specified employers only (e.g., for one specified hospital) does not qualify for the exclusion. The reference to broad classes of employers is designed to require that the loan agreement encourage the performance of services in areas of need without serving as indirect compensation from a specified employer or employers. The professions to which the provision refers are medicine, nursing, and teaching.

The Act also broadens the exclusion originally provided by the 1976 Act to apply to discharge of student loans made by a tax-exempt (under sec. 501(c)(3)) public benefit hospital corporation which has assumed control over a State, county, or municipal hospital and whose employees have been deemed to be public employees under State law. This provision applies to student loans made directly by such corporation or made by the educational institution with funds provided for that purpose by the hospital corporation. This provision is intended to apply only to public benefit hospital corporations (e.g., the New York City Health and Hospitals Corporation) which perform services essentially equivalent to services performed in other jurisdictions by State or public hospitals.

Effective Date

The provision applies retroactively to discharges of indebtedness made on or after January 1, 1983.

Revenue Effect

This provision is estimated to reduce budget receipts by less than $5 million annually in fiscal year 1984 and later years.

7. Migratory Bird Hunting and Conservation Stamps (Duck Stamps) (sec. 1077 of the Act and 16 U.S.C. 718e and 18 U.S.C. 504(1)(D))[76]

Prior Law

Federal anticounterfeiting laws forbid any reproduction of migratory bird hunting and conservation stamps (duck stamps) because they are considered a type of Federal obligation, like a postage stamp. Under prior and present law, limited reproduction of U.S. revenue stamps is permitted for philatelic, numismatic, educational, historical, or newsworthy purposes, and only black and white illustrations may be made.

Reasons for Change

Congress believed that authorization of color as well as black and white reproductions of duck stamps for commercial purposes is appropriate so long as anticounterfeiting safeguards are observed. Changing the statute to allow color reproductions makes it possible for commercial business to make reproductions of the stamps or facsimiles of them for attaching to commercial products. There is particular interest in reproductions currently because of the 50th anniversary of duck stamps. Fees received from licenses, plus any additional funds from any collateral enhancement of duck stamp sales, will be used for migratory bird conservation activities.

Explanation of Provision

The Secretary of the Interior, with the concurrence of the Secretary of the Treasury, is authorized to license color, as well as black and white, reproductions of duck stamps. The reproductions must be less than three-fourths, or more than one and one-half, of the size of the original stamp. The proceeds from such licensed reproductions will be deposited in the Migratory Bird Conservation Fund. Reproductions may be made for commercial purposes which may include facsimiles on such products as placemats and shotguns.

The Act also permits the color reproduction of duck stamps in philatelic (or stamp-collecting) advertising designed to encourage collectors to purchase duck stamps. Duck stamp reproductions used in philatelic advertising will not be subject to the licensing requirements, but they otherwise will have to conform to the requirements imposed under anticounterfeiting provisions.

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[76] For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 887; S. Prt. 98-169, Vol. I (April 2, 1984), p. 932; and H. Rep. No. 98-861 (June 23, 1984), pp. 1279-1280 (Conference Report).

Effective Date

The provision became effective on the date of enactment (July 18, 1984).

Revenue Effect

This provision is estimated to increase revenues by a negligible amount.

8. Boundary Waters Canoe Act Payments (sec. 1078 of the Act)[77]

Prior Law

The Boundary Waters Canoe Area Wilderness Act of 1978 designated sites in the Boundary Waters Canoe area to be developed for recreational purposes within limits consistent with the expressed policy to protect the special qualities of the areas as natural forest-lakeland wilderness ecosystems of major recreational and educational value. Statutory limits were imposed on various activities in the area, including motorboating. The size of motors usable on certain lakes is limited to 25 horsepower or 10 horsepower. On other lakes, only canoes are allowed on the waters. In all of these areas, resort operators have had to adjust their mode of operation, and some motorboat outfitters have had to dispose of entire inventories of motorboats and replace them with canoes.

The Act also authorized the appropriation of funds that would enable the Secretary of Agriculture, operating through the U.S. Forest Service, to develop technical and financial assistance programs to help qualified resort operators and commercial outfitters who had operated in certain of the areas. The assistance program was developed with two parts. The first part provided $2,500 to be used for conversion from powerboat to canoe operations, trading down to smaller boats, improving resort areas, and other similar uses. The second part involved equity-grants awards limited to 25 percent of an applicant's projected costs, up to $50,000, to upgrade resort and outfitting businesses. The equity-grants awards were to be supplemented by loans for the remaining portion of projected costs, and the loans were to be obtained from government and private sources. All qualified applicants were expected to have had an opportunity to apply for assistance by the end of fiscal year 1982. In the event that a recipient of an equity-grant award sold the business, the terms of the grant required repayment of the grant in three parts.

Reasons for Change

Because of the wilderness designation, resort operators have been forced to change their mode of operation and to dispose of certain equipment. Thus, this designation has had an economic effect similar to an involuntary conversion, and Congress believed that the affected taxpayers should receive tax treatment similar to that accorded an involuntary conversion.

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[77] For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 888; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 936-37; and H. Rep. No. 98-861 (June 23, 1984), pp. 1280-1281 (Conference Report).

Explanation of Provision

In general, the Act permits resort operators and boat outfitters to make tax-free reinvestments of equity-grants provided under the Boundary Waters Canoe Wilderness Act in depreciable property for use in activities allowed within the Boundary Waters Canoe Areas. The taxpayer's basis in the property is to be reduced by the amount of the equity grant. The property to which payments are allocated must be placed in service before the later of two years after the date of enactment or two years after the payment is received.

Under the Act, the taxpayer may elect to exclude from gross income the excludable portion of payments received from the U.S. Forest Service under the programs developed following the imposition of restrictions on motorized traffic in the Boundary Waters Canoe Area. The excludable portion is defined in the statute as that portion (or all) of a payment made to the taxpayer during the period between December 31, 1979, and two years after the later of the date of enactment of this Act or the date of the payment, which is reinvested during that period in depreciable assets used in the taxpayer's trade or business as authorized in the Boundary Waters Canoe Area Wilderness Act.

When making an election with respect to the excludable portion of payments, the taxpayer shall identify the assets for which the payment has been allocated. The basis of any asset to which the taxpayer elects to allocate any portion of a payment shall be reduced by the amount of the payment. The basis of any such asset shall be increased by the amount of any repayments to the U.S. Forest Service on the sale of the asset. No deduction (such as a depreciation deduction under ACRS) or credit will be allowed with respect to the portion of any expenditure for property that has been funded by any amount excluded from gross income under this provision.

This election may be made at any time before the expiration of the period for making a claim for credit or refund for the taxable year in which the reinvestment occurred. The Secretary shall prescribe the manner in which the election may be made in regulations.

Effective Date

The amendments made by this section apply to payments made in taxable years beginning after December 31, 1979.

Notwithstanding any other provisions in the Internal Revenue Code that relate to a period of limitation or lapse of time, a claim for credit or refund of overpayment of tax with respect to payments described in this section which were made after December 31, 1979, may be filed by the taxpayer with the allocation election within one year after the date of enactment.

Revenue Effect

This provision is estimated to affect revenues by a negligible amount in fiscal years 1984 and 1985.

9. Tax-Exempt Status of U.S. Instrumentalities Organized Under Acts of Congress (sec. 1079 of the Act and sec. 501 of the Code) [78]

Prior Law

Under prior law (Code sec. 501(c)(1)), a corporation organized under a Federal statute (including nonrevenue laws) that constituted an instrumentality of the United States was exempt from Federal income tax if the statute expressly provided for such exemption. A tax exemption also could be provided by a specific provision enacted as an amendment to the Internal Revenue Code.

Reasons for Change

In connection with amending Code section 501 to provide Federal income tax exemption for the National Credit Union Central Liquidity Facility,[79] Congress decided that any further statutory tax exemption provisions for corporations constituting U.S. instrumentalities should be set forth in the Internal Revenue Code or in a non-Code provision of a Revenue Act. This will allow more effective monitoring of statutory tax exemptions for U.S. instrumentalities, which have increased in number in recent years.

Explanation of Provision

The Act specifies that instrumentalities of the United States (other than the Central Liquidity Facility) are to be exempt from Federal income tax only if (1) the exemption is specifically provided in the Federal statute organizing the instrumentality, as in effect before July 18, 1984, or (2) the exemption is provided in the Internal Revenue Code or in a Revenue Act. Thus, under the Act, future Federal income tax exemptions for instrumentalities of the United States may be provided only by an amendment to the Internal Revenue Code or by a provision (not amending the Code) enacted as part of a Revenue Act.

Effective Date

The provision became effective on the date of enactment (July 18, 1984).

Revenue Effect

The provision will not have any effect on budget receipts.

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[78] For legislative history of the provision, see H. Rep. No. 98-861 (June 23, 1984), pp. 1278-1279 (Conference Report); H. Con. Res. 328, 130 Cong. Rec. S. 8948 (June 29, 1984), H. 7529 (June 29, 1984).

[79] *See* description of Act section 2813, Part IV. 6., infra.

I. Studies

1. Study of Alternative Tax Systems (sec. 1081 of the Act)[80]

Prior Law

Studies of alternative tax mechanisms were not mandated in prior law.

Reasons for Change

Congress believed that the current system of income taxation is unduly complex. The large number of tax preferences and special deductions, credits and exclusions increase compliance and administration costs, and undermine the taxpayers' confidence in the fairness of the Internal Revenue Code. Non-uniform taxation distorts individual and corporate economic decisions, thereby lowering economic efficiency. For these reasons, Congress believed that it is desirable to study the effects of a more comprehensive tax base. Congress believed that alternatives which increase the simplicity, efficiency and fairness of the tax system should be carefully studied.

Explanation of Provision

The Act requires the Secretary of the Treasury to conduct a study of the advisability of replacing the Federal individual income tax, or both the Federal individual income tax and the Federal corporate income tax, with an alternative tax system. For this purpose, the Secretary is required to study (1) a simplified income tax based on gross income, (2) a consumption tax, (3) a consumption-based tax, and (4) the broadening of the base and lowering of the rates of the current income tax system.

The Treasury study is to consider the administrative complexity of the existing Federal income tax system and to address the ramifications of replacing the existing system with an alternative system. The study is to focus on (but not be limited to) the following factors: (1) protecting the economically disadvantaged; (2) increasing economic efficiency in both the private amd public sectors of the economy; (3) reducing paperwork and auditing requirements, reducing taxpayer fraud and evasion, and expediting resolution of tax disputes between taxpayers and the Federal Government; (4) increasing economic incentives for capital formation and productivity, (5) removing economic disincentives to employment, (6) excluding certain items from gross income, (7) equalizing the tax burden on taxpayers with equal ability to pay taxes, and (8) achieving the

[80] For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 494; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), p. 1585; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, secs. 164 and 886; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 459, 931; and H. Rep. No. 98-861 (June 23, 1984), 1283 (Conference Report).

appropriate burden of taxes for each income class of taxpayers. The study also should deal with tax shelters and specifically report on possible extensions or expansions of the minimum tax requirements, extension or revision of "at-risk" and "recapture" rules, the impact of changing depreciation methods to more closely reflect economic depreciation and of providing a full basis adjustment for the business tax credits, and proposals to limit the deductibility of artificial accounting losses.

The Treasury is required to submit a report to the Senate Committee on Finance and the House Committee on Ways and Means not later than December 31, 1984.[81]

Effective Date

The provision became effective on enactment (July 18, 1984).

Revenue Effect

The provision has no effect on budget receipts.

[81] The Treasury Department released a 3-volume study, with recommendations to the President in November 1984, entitled, "Tax Reform for Fairness, Simplicity, and Economic Growth".

2. Treasury Study on Foreign Taxation of Certain U.S. Services (sec. 1082 of the Act)[82]

Prior Law

U.S. treatment of foreign taxes—in general

U.S. persons[83] are taxable on their worldwide income, including their foreign income. However, the foreign tax credit allows U.S. taxpayers to offset the U.S. tax on their foreign income by the income taxes paid to a foreign country.

The foreign tax credit was enacted to prevent U.S. taxpayers from being taxed twice on their foreign income—once by the foreign country where the income is earned and again by the United States as part of the taxpayer's worldwide income. The foreign tax credit system embodies the principle that the country in which a business activity is conducted (or in which any income is earned) has the first right to tax any or all of the income arising from activities in that country, even though the activities are conducted by corporations or individuals resident in other countries. Under this principle, the home country of the individual or corporation has a residual right to tax income arising from these activities, but recognizes the obligation to prevent double taxation.

Foreign tax credit limitation

A fundamental premise of the foreign tax credit is that it should not offset the U.S. tax on U.S. foreign income. Accordingly, a statutory formula limits the foreign tax credit to insure that the credit will offset only the U.S. tax on the taxpayer's foreign income. Under the formula, the larger the proportion of a taxpayer's worldwide income in a given year that is treated as from U.S. sources, the less foreign taxes the taxpayer may be able to credit in that year.

The foreign tax credit limitation tends both (1) to prevent other countries from taxing the U.S. tax base, and (2) to discourage U.S. taxpayers from operating in countries that tax the U.S. tax base. Without the limitation, U.S. taxpayers who paid enough high foreign taxes might operate tax-free in the United States. U.S. taxpayers would tend to become indifferent to high foreign tax rates, because the U.S. Treasury would absorb the foreign tax burden.

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[82] For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 889; S. Prt. No. 98-169, Vol. I (April 2, 1984), pp. 933-35; and H. Rep. No. 98-861 (June 23, 1984), pp. 1283-84 (Conference Report).

[83] U.S. persons are U.S. citizens, U.S. residents, U.S. partnerships, U.S. corporations, and, generally, U.S. trusts and estates (Code sec. 7701(a)(30)).

Source of income—U.S. or foreign

For the foreign tax credit mechanism to function, every item of income must have a source, that is, it must arise either within the United States or outside the United States.

The United States treats compensation for personal services performed in the United States as U.S.-source income (sec. 861(a)(3)). This income is U.S.-source income even though the person paying for the services resides in a foreign country and uses the services in a foreign country. For example, payments for a blueprint drawn in the United States for use in a foreign country are U.S.-source income.

The U.S. Model Income Tax Treaty (which represents the U.S. income tax treaty negotiating position) and the Model Treaty of the Organization for Economic Cooperation and Development adopt the U.S. statutory rule that only the country where the services are performed may tax this income (Article 7 (Business Profits), Article 14 (Dependent Personal Services)). Most developed countries use this rule.

Some foreign countries, expecially developing countries, have a tax source rule different from the U.S. rule, however. They treat income from personal services as having its source in the country where the services are used. Generally, in a developing country, the total value of services used is greater than the total value of services performed. A place-of-use source rule therefore gives a developing country a broader tax base than a place-of-performance source rule. Like the United States, these countries will insist on taxing income they consider from sources within their borders. Therefore, these countries and the United States insist on taxing the same income. Double taxation arises. Taxes imposed by these countries on income from services performed in the U.S. may not be usable as foreign tax credits in the year paid because the income, being U.S.-source income under U.S. tax law, does not increase the foreign tax credit limitation.

The United States has few treaties with developing countries. However, under the income tax treaty between the United States and Morocco, payments from the Government of Morocco to a U.S. person for technical and economic studies have their source in Morocco (Articles 5(3) and 12(3)(c)). Payments from the private sector to U.S. persons for U.S.-performed services for use in Morocco still have their source in the United States.

Foreign taxation of payments for technical assistance

Many countries impose gross withholding taxes on payments for technical services (such as engineering services, architectural services, and other construction contract services) that a U.S. taxpayer performs in the United States for use within their borders. Some countries waive or reduce these taxes in negotiations with foreign taxpayers on a case-by-case basis. Others reduce them through tax treaties.

Reasons for Change

The Congress was concerned that the treatment of income from services performed in the United States by U.S. persons for foreign persons for use abroad, as foreign income, and its taxation as such by foreign countries, may subject U.S. persons to double taxation. The Congress believed that the sourcing of income from personal services based on where the services are used, rather than performed, may be undertaken by some foreign countries to broaden artificially their tax bases at the expense of countries such as the United States that apply the generally-accepted place-of-performance sourcing rule. The Congress was uncertain, however, how the United States should best address this problem. Accordingly, the Congress decided that the Treasury Department should study the problem and report back to the Congressional tax-writing committees.

Explanation of Provision

The Act directs the Treasury Department to study the practices of foreign countries that impose taxes on the basis of services that are performed in the United States, including the status of treaty negotiations with such countries, and options to alleviate the resulting double tax burden on U.S. taxpayers. The Act requires the Treasury Department is to report on the results of its study to the House Committee on Ways and Means and the Senate Committee on Finance no later than December 31, 1984.[84]

Effective Date

This provision became effective on the date of enactment, July 18, 1984.

Revenue Effect

This provision will not have any effect on budget receipts.

[84] The Treasury Department transmitted its report to Congress on October 3, 1984. The report appears on pages S13772-77 of the Congressional Record of October 5, 1984.

IV. GENERAL EXPLANATION OF OTHER TAX-RELATED PROVISIONS WITHIN THE JURISDICTION OF THE COMMITTEE ON WAYS AND MEANS AND THE COMMITTEE ON FINANCE

A. Special Social Security Treatment for Church Employees (sec. 2603 of the Act, secs. 1402 and 3121 of the Code, and secs. 210 and 211 of the Social Security Act)[1]

Prior Law

FICA and self-employment taxes

The Federal Insurance Contributions Act (FICA) imposes separate taxes on employers and employees equal to a percentage of wages paid as remuneration for employment, subject to certain exceptions. These taxes are used to fund the social security programs of Old-age and Survivors' Insurance, Disability Insurance and Hospital Insurance. The 1984 FICA tax rates were 7 percent each for employers and employees (a combined rate of 14 percent); a credit against the employee FICA tax of 0.3 percent of 1984 wages was allowed. These rates are scheduled to increase in stages until reaching a maximum of 7.65 percent each for employers and employees (a combined rate of 15.3 percent) in 1990. The amount of wages subject to FICA tax is limited to a ceiling ($37,800 in 1984), adjusted annually for increases in average wages. Both the employee and employer FICA taxes are paid to the Internal Revenue Service by the employer (in the case of employee taxes, after withholding these taxes from the employee's wages) and amounts equal to the taxes imposed are deposited in the social security trust funds.

For self-employed individuals, a tax is imposed on self-employment income under the Self-Employment Contributions Act (SECA). This tax equaled 14 percent of self-employment income in 1984 and is scheduled to increase to 15.3 percent by 1990, i.e., the rates are equal to the combined employer-employee FICA tax rates. However, for years through 1989, self-employed individuals are allowed a credit against the tax for a portion of self-employment income (2.7 percent in 1984). Thus, the net rate of SECA tax is somewhat lower than the combined FICA rate. Thereafter, self-employed individuals are permitted special deductions designed to treat them in much the same manner as employees and employers are treated for social security and income tax purposes. The SECA tax does not apply to income which (together with wages) exceeds

[1] For legislative background of the provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 981; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 986-991; Senate floor amendment, 130 Cong. Rec. S4122 (April 9, 1984); and H. Rep. No. 98-861, (June 22, 1984) (Conference Report).

the FICA ceiling; additionally, the tax does not apply if self-employment income for the for the taxable year is less than $400.

Certain classes of employees, including employees of foreign governments and international organizations, are treated as self-employed for purposes of social security taxes under prior and present law.

Employees of religious organizations

Prior to the Social Security Amendments of 1983 (P.L. 98-21), employees of nonprofit religious, charitable, educational, or other tax-exempt organizations described in section 501(c)(3) of the Code were covered by social security only if the organization waived (or was deemed to have waived by reason of actual payment of FICA taxes) its exemption from social security taxation. Organizations for whom coverage had been in effect for at least 8 years were entitled to terminate coverage upon 2 years' advance notice to the Treasury Department.

The Social Security Amendments of 1983 extended mandatory social security coverage to employees of nonprofit organizations (including religious organizations), effective January 1, 1984. This coverage applied to employees of organizations which had previously terminated coverage as well as to employees of organizations which had never been covered by social security. Wages of an employee of a tax-exempt organization were excluded from social security for tax and benefit purposes if less than $100 was paid to the employee in a calendar year.

Ministers and certain members of religious orders

Under prior and present law, employees who are ministers of a church in the exercise of their ministry or members of religious orders (other than members subject to a vow of poverty) in the exercise of duties required by the order are treated as self-employed individuals for purposes of social security taxes. Such individuals who are conscientiously, or because of religious principles, opposed to participation in a public insurance system may elect to be exempt from self-employment taxes and credit under social security (on earnings for services as ministers or members of religious orders) by filing an irrevocable one-time application to that effect within two years of beginning their ministry. The treatment of ministers and members of religious orders not subject to a vow of poverty was not affected by the 1983 social security amendments.

Reasons for Change

The Congress remained committed to the policy of the 1983 amendments in extending mandatory social security coverage to employees of nonprofit organizations. Such employees are thereby assured protection under the old-age, disability, and hospital insurance programs of social security. In addition, the problem of windfalls accruing to workers with short periods of covered employment is reduced. The Congress was aware, however, of the special concerns which arise when a mandatory Federal tax (i.e., the employer FICA tax) applies to activities of a religious organization.

The Act attempts to resolve these concerns while maintaining mandatory social security coverage for employees of religious organizations and while continuing to provide equity between employees of religious organizations and other nonprofit organizations. Thus, the Act allows churches and certain church-controlled organizations which would have been exempt from FICA taxes under prior law (absent a waiver) to make a one-time election to treat their employees similarly to self-employed individuals for purposes of social security taxes. The election is limited to such churches and qualified church-controlled organizations which state that they are opposed for religious reasons to the payment of social security taxes. In adopting this provision, the Congress did not intend to express any opinion regarding the constitutionality of the original coverage provisions of the 1983 social security amendments.

If a church elects such treatment under the Act, its employees are to pay tax at a rate equal to or approaching the combined employee-employer FICA rate (that is, at the SECA rate less the credit against SECA taxes), and are entitled to credit for their earnings, for benefit purposes, equivalent to that received by employees of other nonprofit organizations. No social security taxes are imposed directly upon the church. The Congress believed that this approach will result in equitable treatment for employees of religious organizations without impinging upon the separation of church and state. To ensure compliance with the self-employment tax provisions, the Act provides that the election remains in effect only for so long as the organization electing self-employment treatment for its employees provides information to the Internal Revenue Service regarding wages paid to employees.

In addition to elections by churches, the Act allows an election to treat employees of certain church-controlled tax-exempt organizations similarly to self-employed individuals. However, many church-controlled organizations (including church-controlled universities and religious hospitals) provide services to the general public which are similar in nature to those provided by other, secular institutions. Allowing an election in these cases would result in differing treatment for employees of religious and secular organizations performing essentially similar functions (e.g., nurses in religious hospitals as opposed to nurses in secular facilities). Further, where an organization sells its services to the general public, concerns regarding the separation of church and state become less pressing.

To meet the concerns above, the Act therefore does not allow an election to church-controlled organizations which offer goods, services, or facilities for sale to the general public (other than those offered on an incidental basis or for a nominal charge) and which normally receive more than 25 percent of their support from governmental sources, from sales or similar receipts, or from both such sources. (Because an election is not allowed with respect to services performed in an unrelated trade or business, these trades or businesses are excluded from the computation.) The Congress believed that these rules provide a fair, objective test for determining those organizations entitled to make an election without questioning the religious connection of any particular organization. Also, for purposes of this provision, church-supported elementary and secondary schools are allowed to make an election regardless of the two tests described above.

Explanation of Provision

General rules

The Act allows a church or qualified church-controlled organization to make a one-time election to exclude from the definition of employment, for purposes of FICA taxes, services performed in the employ of the church or organization. This exclusion does not apply to services performed in an unrelated trade or business (within the meaning of sec. 513(a)) of the church or organization. This election may be made only if the electing church or organization states that it is opposed for religious reasons to its paying social security taxes as an employer.

If an election is made to exclude services for FICA purposes, the employee is treated similarly to a self-employed person with respect to those services. Thus, the employee is liable for SECA taxes on remuneration for such services. This tax is imposed at the usual self-employment tax rate under section 1402 of the Code, and is subject to the general self-employment tax credits for 1984 through 1989 and the special SECA deduction provisions thereafter. Thus, in 1984 the net rate of tax is 11.3 percent (14 percent less the credit of 2.7 percent).

The Act does not affect the employment tax status of ministers of a church or members of a religious order.

Procedure for making election

An election by existing or newly created organizations to exclude services for FICA purposes must be made prior to the first date, more than 90 days after enactment of the provision (July 18, 1984), on which a quarterly employment tax return is or would otherwise be due from the electing organization. Thus, organizations for whom a return is (or would otherwise be) due on October 31, 1984 (generally, organizations with employees on, and in existence no later than, September 30, 1984, must make an election by October 30, 1984, while organizations whose first return is (or would otherwise be) due at a later date must make the election prior to that date (disregarding any extension of the due date). An election applies to all current and future employees of the electing organization for services performed on or after January 1, 1984.

The election must be made in accordance with such procedures as the Treasury Department determines to be appropriate. Once made, an election may not be revoked by the electing organization.

Eligibility to make election

An election may be made by a church described in section 501(c)(3) or a qualified church-controlled organization. For purposes of this provision, the term church includes (1) a convention or association of churches and (2) an elementary or secondary school which is controlled, operated, or principally supported by a church or by a convention or association of churches. The churches, conventions or associations of churches, and church-controlled elementary or secondary schools eligible for the election under the Act are those which could have qualified for exemption (absent a waiver) from FICA taxes under prior law, i.e., those which are described in Code section 501(c)(3) and are exempt from Federal income tax under section 501(a).

The term qualified church-controlled organization means any church-controlled tax-exempt organization described in Code section 501(c)(3), *other than* an organization which both (1) offers goods, services, or facilities for sale, other than on an incidental basis, to the general public (e.g., to individuals who are not members of the church), other than goods, services, or facilities which 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 percent of its support from either (a) governmental sources or (b) receipts from admissions, sales of merchandise, performance of services, or furnishing of facilities in activities which are not unrelated trades or businesses, or from (a) and (b) combined.

An otherwise qualified organization is ineligible to make an election as a qualified church-controlled organization only if both conditions (1) and (2) in the preceding paragraph exist. Thus, the typical seminary, religious retreat center, or burial society would generally qualify to make an election, regardless of its funding sources, because it does not offer goods, services, or facilities for sale to the general public. A church-run orphanage or old-age home would qualify, even if it is open to the general public, if not more than 25 percent 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. However, where both conditions (1) and (2) exist, the organization would not be eligible to make an election. Congress specifically intended that church-run universities (other than religious seminaries) and hospitals are not eligible to make an election, if both conditions (1) and (2) exist.

Auxiliary organizations of a church (including youth groups, women's auxiliaries, etc.) would generally satisfy neither of the conditions and would thus be eligible to make an election. Similarly, church pension boards or fund-raising organizations generally would qualify to make an election.

Information reporting requirements

An organization electing to exclude services for FICA purposes nonetheless continues to be required to furnish relevant information required of employers subject to income tax withholding (sec. 6051), including information with respect to the identity of employees and the amount of wages paid to each employee. The organization's election is to be permanently revoked by the Treasury if the organization fails to provide such information for a period of two years or more and, upon request by the Treasury Department, fails to furnish previously unfurnished information for the period covered by the election. Such revocation would apply retroactively to the beginning of the two-year period for which there was a failure to furnish such information.

Amount of remuneration subject to SECA taxes

The remuneration on which the employee of an electing institution is to be liable for SECA tax generally is the same as the amount which would have been subject to FICA tax if that individual had continued to be treated as an employee. Thus, such employees are not eligible for the exemption from SECA provided in section 1402(g) for members of certain religious faiths. Also, trade or business expenses are not subtracted in computing self-employment income (reimbursed business expenses are not to be included in self-employment income, however), and the $400 threshold on self-employment income does not apply. Similarly, a $100 threshold (per employer) for a taxable year applies in determining whether remuneration for services covered by an election is subject to SECA tax. However, after 1989 these employees will be eligible for a deduction, in computing SECA taxes, for the product of net earnings from self-employment and one-half of the SECA rate.

Refunds of taxes previously paid

If a church or qualified church-controlled organization which makes an election to exclude services for FICA purposes has paid FICA taxes for services performed after December 31, 1983, that are covered by the election, the Treasury must refund such taxes (without interest) to the electing organization. However, this refund is available only if the electing organization agrees to pay to each present (or former) employee that portion of the refund which is attributable to the employee portion of FICA taxes collected by the organization from such employee. The employee is not entitled to any other refund for such taxes.

Estimated taxes

The Act generally requires employees of electing institutions to make estimated tax payments with respect to their SECA liability. However, it is intended that employees who become liable for SECA taxes for 1984 because of an election by their employer made before the first date, more than 90 days after the date of enactment (July 18, 1984), on which a quarterly employment tax return is generally due, are to be relieved of estimated tax penalties attributable to underpayment of SECA taxes with respect to quarters of 1984 prior to the date by which the election is required to be made (Code sec. 6654(e)(3)(a), as added by sec. 411 of the Act).

Effective Date

This provision is effective for services performed after December 31, 1983.

Revenue Effect

This provision is estimated to reduce fiscal year budget receipts by $67 million in 1984, $16 million in 1985, $12 million in 1986, $6 million in 1987, $9 million in 1988, and $3 million in 1989.

B. Disclosure of Tax Return Information to Verify Income and Eligibility for Specified Federal Benefits (sec. 2651 of the Act, sec. 6103 of the Code, and sec. 1136 of the Social Security Act)[2]

Prior Law

Under prior and present law, tax information concerning wages, self-employment income, and retirement income may be disclosed to State welfare agencies for use in administering aid to families with dependent children (AFDC) (sec. 411 of the Social Security Act) and food stamps (sec. 6103(*l*)(7) of the Code), and to the Social Security Administration for purposes of administering the supplemental security income (SSI) program (see sec. 6103(*l*)(1)(A) of the Code). Under prior law, tax information concerning unearned income could not be disclosed to these agencies.

Reasons for Change

Congress believed that wage and nonwage information should be available to agencies administering specified needs-based programs to enable those agencies to make more accurate determinations of both eligibility for benefits and the amount of benefits properly payable.

Explanation of Provision

The Act provides that the Commissioner of Social Security must disclose tax information concerning wages, self-employment income, and retirement income to an authorized agency. The Act also provides that the Commissioner of Internal Revenue must disclose tax information concerning unearned income to an authorized agency. Authorized agencies are any Federal, State, or local agency that administers one of these programs: (1) aid to families with dependent children; (2) Medicaid; (3) supplemental security income benefits; (4) the cash assistance programs administered in Puerto Rico, Guam, and the Virgin Islands; (5) unemployment compensation; (6) food stamps; and (7) optional State supplementation of payments.

Disclosure can be made only for purposes of, and to the extent necessary in, determining eligibility for, or the correct amount of, benefits under one of these programs. The agency must request dis-

[2] For legislative background of this provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 991; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 993-994; H.R. 5362, reported by the House Committee on Ways and Means on April 9, 1984, secs. 101-102; H. Rep. No. 98-664 (April 9, 1984), pp. 6-8; H.R. 5394, sec. 621-622, 130 Cong. Rec. H. 2508 (April 9, 1984); House agrees to H. Res. 483 and passes H.R. 5394, 130 Cong. Rec. H. 2797 (April 12, 1984); H.R. 4170, House amendment to the Senate amendment incorporating the provisions of H.R. 5394 into H.R. 4170, secs. 2621-2622, 130 Cong. Rec. H. 4583, 4698-4700 (May 23, 1984, pt. II); and H. Rep. No. 98-861 (June 23, 1984), pp. 1410-1412 (Conference Report).

closure by means of a written request. The agency must establish the same safeguards against unauthorized disclosure of the information that all other recipients of tax information are required to maintain.

In view of the substantial volume of return information to be disclosed and the number of recipient agencies ultimately involved, it is expected that the Internal Revenue Service will enter into cooperative agreements with the Federal agencies administering these programs, providing for centralized disclosure of this information to these Federal agencies by the Internal Revenue Service by means of computer tapes. The Federal agencies will then redistribute the return information to State and local agencies.

The agency may not use the tax information relating to unearned income obtained from the Internal Revenue Service to terminate, deny, suspend, or reduce the benefits of any individual until the agency has independently verified the information. That is, the agency must independently verify the amount of the asset or income, whether the individual has (or had) access to the asset or income, and the period of time during which the individual had access. The individual must be notified by the agency of the findings it has made based upon the verified information. The individual must be given the opportunity to contest those findings, in the same manner that the individual may contest other findings relating to eligibility under the program.

Effective Date

The provision requiring disclosure of wage and unearned income tax information became effective on July 18, 1984. The provision relating to verification of unearned income is effective on April 1, 1985, except that a waiver may be granted to a State that submits a good faith plan for compliance. The waiver may not extend beyond September 30, 1986.

C. Collection of Nontax Debts Owed to Federal Agencies (sec. 2653 of the Act, sec. 6402 of the Code, and sec. 3721 of title 31, United States Code)[3]

Prior Law

Under prior and present law, tax refunds must be offset against past-due child support and spousal support payments in the case of families receiving AFDC payments. Prior law did not provide authority for the Internal Revenue Service to offset tax refunds against nontax debts owed to Federal agencies.

Reasons for Change

Congress believed that the collection of nontax debts owed to the Federal Government should be facilitated. Congress also believed that there should be an opportunity to evaluate the effectiveness of collecting nontax debts owed to Federal agencies by offsetting tax refunds against these debts. Consequently, Congress provided that this provision will become effective in 1986 and will expire at the end of 1987. Congress believed that this provision should be evaluated by examining the extent to which it facilitates the collection of debts owed the Federal Government and increases the amount of debts collected, as well as the effect of this provision on taxpayer compliance with the income tax law.

Explanation of Provision

The Act amends Code section 6402 to provide that the amount of any refund of Federal taxes (such as individual or corporate income taxes) is to be reduced by the amount of any certified debt owed to the Federal Government. The agency responsible for collecting the debt must certify to the Treasury that specific attempts to notify the debtor have been made and that the debtor has not disputed the nature or amount of the debt (or any dispute has been resolved by agreement between both the debtor and the agency), has not begun to repay the debt, and exhibits no reasonable intention to repay the debt. Further, the Secretary of the Treasury may prescribe by regulations other conditions to be met by the agency to ensure that the agency has made reasonable efforts to obtain payment of the debt, such as disclosing the fact of the delinquent debt to a consumer reporting agency as authorized under current law (see 31 U.S.C. 3711(f)). The agency must have entered into an agreement with the Secretary providing for the transmission of certified debt information before actual transmission occurs.

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[3] For legislative background of this provision, see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 993; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 996-997; and H. Rep. No. 98-861 (June 23, 1984), p. 1413 (Conference Report).

The Secretary is given the authority to prescribe the terms of agreements with other agencies. The Secretary will prescribe the format in which the information must be transmitted. In addition, the Secretary is authorized to test the offset procedures with selected agencies at first, before fully implementing the provision. The Secretary is authorized to disclose to the Federal agency the amount being offset against the debt for the purpose of, and only to the extent necessary in, administering this offset procedure. The agency must establish the same safeguards against unauthorized disclosure of the information that all other recipients of tax information are required to maintain.

If a refund is subject to offset both under this provision and because of AFDC past-due support, the offset for AFDC past-due support is to be implemented first. If the Secretary receives notice from one or several Federal agencies under this provision of more than one debt to be offset, the offsets take place in the order in which the debts accrued. Consequently, agencies must inform the Secretary of the date the debt accrued.

The Act provides that no court of the United States shall have jurisdiction to hear any action brought to restrain or review a refund offset made because of either past-due child support or a nontax Federal debt. The Act also provides that no action brought against the United States to recover the amount of the offset shall be considered to be a suit for refund of tax. The Act prohibits the Secretary from reviewing in an administrative action any offset, other than performing the ministerial tasks of determining whether the amount to be offset has been properly referred to the Internal Revenue Service. The Act specifies that these provisions do not preclude any legal, equitable, or administrative action against the Federal agency to which the amount offset was paid.

Effective Date

The provision is effective for refunds payable after December 31, 1985, and before January 1, 1988.

D. Limitation on Cover Over (Payment) of Certain Federal Excise Taxes to Puerto Rico and the Virgin Islands (sec. 2681 of the Act and sec. 7652 of the Code)[4]

Prior Law

A special excise tax is imposed on articles coming into the United States from Puerto Rico or the Virgin Islands. The tax is equal to the Federal excise tax that would be imposed if the articles were manufactured in the United States (Code sec. 7652). This tax is in lieu of the excise tax that would be imposed if the articles were so manufactured or imported.

Revenues collected from the tax on articles coming into the United States from Puerto Rico or the Virgin Islands are covered over (paid) to the treasury of the possession from which the articles come. No restrictions were imposed under prior law on the use of these revenues by Puerto Rico or the Virgin Islands.

Beginning in 1983, the Government of Puerto Rico sponsored a redistillation program under which spirits originally distilled in the United States were transported to Puerto Rico and redistilled in that possession. Following redistillation, the spirits were returned to the United States for processing and marketing. As a result of their redistillation in Puerto Rico and return to the United States, the Puerto Rican Government received a payment of $10.50 per proof gallon with respect to these redistilled spirits (i.e., the amount of excise tax imposed on the distilled spirits) because redistillation was considered to be Puerto Rican production.

Reasons for Change

Congress was concerned that Federal excise tax revenues were being paid to Puerto Rico when little or no economic nexus existed between the articles with respect to which the payments were made and Puerto Rican input into the production of these articles. Congress believed that payment of Federal excise tax revenues to Puerto Rico and the Virgin Islands should not continue with respect to articles not having a substantial economic nexus with those possessions. The redistillation program sponsored by Puerto Rico involved a process that likely would not have occurred without (1) the availability of Federal excise tax payments to Puerto Rico, and (2) the availability of subsidies by Puerto Rico to participants in the redistillation program.

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[4] For legislative background of the provision see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 135; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), p. 1334; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 996; S. Prt. 98-169, Vol. I (April 2, 1984), p. 998; H. Rep. No. 98-861 (June 23, 1984), p. 1418 (Conference Report); and H. Con. Res. 328, 130 Cong. Rec. S. 8949 (June 29, 1984) and H. 7530 (June 29, 1984).

Congress also was concerned about payment of Federal excise tax revenues with respect to cane neutral spirits because of subsidies provided to producers of those spirits by the Governments of Puerto Rico and the Virgin Islands. Congress believed that permitting these payments to continue could have resulted in adverse competitive pressures on U.S. mainland distillers of cane neutral spirits who receive no similar subsidy.

Finally, Congress determined that additional restrictions to prevent development of new programs designed primarily to produce Federal excise tax payments for Puerto Rico or the Virgin Islands are appropriate.

Explanation of Provisions

Articles containing distilled spirits

The Act limits payments of Federal excise tax revenues to Puerto Rico and the Virgin Islands with respect to articles containing distilled spirits to articles of which at least 92-percent of the alcoholic content is rum. Congress understood that these excise tax payments are determined at the time an article enters the United States. Congress further understood that this determination is not affected by any change in the character of the article after entry into the United States. Therefore, payments will be available with respect to articles containing distilled spirits satisfying the 92-percent test upon entry into the United States even if these spirits subsequently are blended with other distilled spirits into an article not satisfying that requirement. However, if such blending occurs before entry into the United States, the payment will not be available.

Articles other than articles containing distilled spirits

Value-added test for articles from Puerto Rico

Under the Act, payments of excise tax revenues are permitted with respect to any article (other than an article containing distilled spirits) coming into the United States from Puerto Rico only if at least 50 percent of the value of the article at the time it comes into the United States is attributable to Puerto Rican input. The factors that are considered in determining Puerto Rican input are labor and material costs and direct costs of processing operations. Direct costs of processing operations include those costs that are considered under section 213 of the Caribbean Basin Initiative Act. As with articles containing distilled spirits, modification of any article subsequent to the time it is brought into the United States is not considered when determining the value of the article or the percentage of the value attributable to Puerto Rican input.

Federal excise tax subsidy prohibition

Under the Act, no payment of Federal excise tax revenues is permitted for any article (other than an article containing distilled spirits) if Puerto Rico or the Virgin Islands provides a direct or indirect subsidy with respect to the article unlike subsidies provided with respect to articles not subject to Federal excise tax. A subsidy is unlike other subsidies if it is (1) of a different kind or (2) in a larger amount per value or volume of production. For example, payment of excise tax revenues is not permitted with respect to an article if the cost of raw materials is subject to price guarantees for a product subject to excise tax when the price of raw materials generally is not guaranteed to manufacturers. Slight variations may exist in otherwise comparable subsidies; therefore, Congress anticipated that the Treasury Department will issue regulations prescribing ranges of allowable differences (i.e., "safe harbors").

Effective Dates

These provisions generally are effective with respect to articles coming into the United States from Puerto Rico or the Virgin Islands after February 29, 1984.

A transition rule permits excise tax payments to Puerto Rico of revenues derived from articles containing redistilled spirits and cane neutral spirits, which articles come into the United States after February 29, 1984, and before January 1, 1985. Under this transition rule, payments of tax not exceeding $130 million may be made during the period July 1, 1983, through June 30, 1984, with respect to redistilled spirits and cane neutral spirits brought into the United States during that period.

Payments of tax not exceeding $75 million, may be made with respect to redistilled spirits during the period July 1, 1984, through December 31, 1984. After June 30, 1984, however, two additional restrictions apply with respect to these payments. First, payments are not permitted with respect to spirits other than redistilled spirits.

Second, so-called "incentive payments" may not be made to any U.S. distiller. Incentive payments include any payment other than reimbursement for direct costs of transportation between the United States and Puerto Rico. An exception to this restriction is provided under which certain U.S. distillers engaged in redistillation operations may continue to receive limited amounts of incentive payments in addition to direct transportation costs through December 31, 1984. These excepted payments may not exceed $1.5 million per U.S. distiller. Congress intended that these excepted payments be limited to payments to the two U.S. distillers (i.e., Glenmore Distilleries and Heublien Spirits Group) that were engaged in redistillation operations before February 29, 1984, and that were entitled to such payments under contracts binding on that date.[5] In determining the amount of incentive payments, Congress intended that the Treasury Department include the amount of price reductions on other products and other indirect payments made by Puerto Rican companies or the Government of Puerto Rico in other transactions between the parties concerned.

Finally, the Act provides that any U.S. distiller who receives incentive payments in excess of $1.5 million between June 30, 1984, and January 1, 1985, is subject to a penalty equal to the total amount of incentive and other payments (other than direct transportation costs) received directly or indirectly from Puerto Rico during the period.

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[5] For purposes of this restriction, the FTG Corporation is not to be treated as a U.S. distiller.

Revenue Effect

These provisions are estimated to reduce fiscal year budget outlays by $185 million in 1985, $276 million in 1986, $296 million in 1987, and $300 million in 1988.

E. Limitation on Transfers of Certain Excise Tax Revenues to Puerto Rico and the Virgin Islands (sec. 2682 of the Act and sec. 7652 of the Code)[6]

Prior Law

A special excise tax is imposed on articles coming into the United States from Puerto Rico and the Virgin Islands. The tax is equal to the Federal excise tax that would be imposed if the articles were manufactured or produced in the United States (Code sec. 7652). This tax is in lieu of the excise tax that would be imposed if the articles were so manufactured or imported.

Under prior law, the full amount of revenues collected from the tax on articles coming into the United States from Puerto Rico or the Virgin Islands was covered over (paid) to the treasury of the possession from which the articles came.

Reasons for Change

Congress was concerned with the effect of the provisions allowing transfer of Federal excise tax revenues to Puerto Rico and the Virgin Islands. Congress decided not to address the overall question of whether payment of Federal excise tax revenues to those possessions is appropriate generally when the revenues are not similarly transferred to the States. Congress believed, however, that this practice should not be expanded absent a thorough examination of the overall issue.

Explanation of Provision

The Act limits the maximum payment with respect to any otherwise qualifying article containing distilled spirits to no more than $10.50 per proof gallon, the amount of the Federal excise tax imposed on distilled spirits before the Act.

Effective Date

This provision is effective with respect to distilled spirits coming into the United States from Puerto Rico or the Virgin Islands after September 30, 1985.

Revenue Effect

This provision will have no significant effect on budget outlays.

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[6] For legislative background of the provision see: "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 997; S. Prt. 98-169, Vol. I (April 2, 1984), p. 1000; and H. Rep. No. 98-861 (June 23, 1984), p. 1420 (Conference Report).

F. Tax Exemption for the National Credit Union Central Liquidity Facility (sec. 2813 of the Act, sec. 501 of the Code, and secs. 303 and 312 of the Federal Credit Union Act)[7]

Prior Law

The National Credit Union Central Liquidity Facility (the "Central Liquidity Facility") was created by Congress in 1978[8] to meet the liquidity needs of credit unions, including the need for short-term adjustment credit, seasonal credit, and protracted adjustment credit in the event of unusual or emergency circumstances.

Prior law did not include a statutory provision specifically exempting the Central Liquidity Facility from Federal, State, or local taxes.

Reasons for Change

Congress believed that the Central Liquidity Facility serves an important Federal purpose in assuring day-to-day access to funds by credit unions and, therefore, should be specifically designated as exempt from Federal income tax and from certain State and local taxes. However, Congress believed that the Central Liquidity Facility should not be entitled to issue Federally tax-exempt obligations and, accordingly specified that no such obligations may be issued.

Explanation of Provision

The Act provides that the Central Liquidity Facility is exempt from Federal income tax under the Internal Revenue Code and from State or local taxes, other than taxes on real property (to the extent that similar property held by other persons is taxed). The Act also amends Title III of the Federal Credit Union Act to clarify that the Central Liquidity Facility is an instrumentality of the United States for all purposes under Federal law.

Under the Act, notes, bonds, debentures, and other obligations issued on behalf of the Central Liquidity Facility, and the income from such obligations, are exempt from State and local taxation (including taxes imposed by U.S. territories, dependencies, and possessions), other than gift, estate, inheritance, legacy, succession, or other wealth transfer taxes. However, such obligations (and the income therefrom) are subject to Federal tax.

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[7] For legislative background of the provision, see: S. 2522, as reported by the Senate Committee on Banking, Housing, and Urban Affairs on April 12, 1984; Senate floor amendment, 130 Cong. Rec. S. 4742 (April 24, 1984); H. Rep. No. 98-861 (June 23, 1984), pp. 1278-1279 (Conference Report); and H. Con. Res. 328, 130 Cong. Rec. S. 8949-50 (June 29, 1984), H. 7531 (June 29, 1984). *See* description of Act section 1079, *supra*, for explanation of provision relating to tax-exempt status of U.S. instrumentalities organized under Acts of Congress.

[8] Pub. L. 95-630, 95th Cong., 2d Sess., November 10, 1978 (12 U.S.C. sec. 1795 et seq.).

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Effective Date

The provision was retroactively effective as of October 1, 1979 (the effective date of the legislation creating the Central Liquidity Facility).

Revenue Effect

This provision is estimated to reduce fiscal year budget receipts by less than $5 million annually.

G. Technical Corrections to the Tax Provisions of the Social Security Amendments of 1983 [9]

1. FICA Treatment of Employer Pickup of Employee Contributions Under State and Local Retirement Plans (secs. 2661(i)(2) and 2661(o)(3) and (4) of the Act, sec. 209 of the Social Security Act, and secs. 3121 and 3306 of the Code)

Prior Law

Prior to the Social Security Amendments of 1983 ("1983 Amendments"), certain employer payments ("pickups") of employee contributions under a State or local retirement plan were treated as wages for social security and unemployment tax purposes only if the payments were made under a salary reduction arrangement. Under the Amendments, all such employer payments are treated as wages.

Explanation of Provision

Congress intended, in the 1983 Amendments, merely to codify the prior law treatment of employer pickups. Thus, the Act amends the provision so that employer pickups are wages, for social security and unemployment tax purposes, only if the pickup is pursuant to a salary reduction agreement (whether evidenced by a written instrument or otherwise). The term salary reduction agreement also includes any salary reduction arrangement, regardless of whether there is approval or choice of participation by individual employees or whether such approval or choice is mandated by State statute.

2. Effective Date for Treatment of Certain Deferred Remuneration (sec. 2662(f)(2) of the Act, and secs. 3121 and 3306 of the Code)

Prior Law

Under the Social Security Amendments of 1983, remuneration paid after services are performed, other than amounts paid under a qualified pension, profit-sharing, or stock bonus plan, generally is taxable when paid, for FICA and FUTA purposes. Amounts deferred under nonqualified deferred compensation plans, however, are included in an employee's FICA and FUTA base when the services for which the amounts are payable are performed or, if later,

[9] For legislation background of the provisions, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, subtitle D of title VI; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1652-1663; H. Rep. No. 98-861 (June 23, 1984), pp. 1413-1415 (Conference Report); and H. Con. Res 328, 130 Cong. Rec. (June 29, 1984).

when there is a lapse of a substantial risk of forfeiture of the employee's right to those amounts.

In general, the provision relating to certain deferred remuneration is effective for remuneration paid after December 31, 1983 (for FICA and social security benefit purposes), and after December 31, 1984 (for FUTA purposes). Under a grandfather rule, in the case of any agreement, in existence on March 24, 1983, between a nonqualified deferred compensation plan and an individual, the provision applies only with respect to remuneration paid that is attributable to services performed after December 31, 1983 (December 31, 1984, for FUTA purposes). As drafted, the treatment for FICA and social security benefit purposes is not clear, for example, for deferred compensation under an agreement not in existence on March 24, 1983, for services performed in 1983 and for which there is no substantial risk of forfeiture at some point during 1983. Further, the grandfather rule does not apply to payments under retirement or termination agreements, other than deferred compensation agreements, which may have qualified for exemption from FICA and FUTA under prior law.

Explanation of Provision

The Act makes two changes in the effective date of the above provisions of the 1983 Amendments. First, in order to eliminate the ambiguity in the tax treatment of nonqualified deferred compensation not subject to the grandfather rule, the Act provides that remuneration, which is paid after December 31, 1983 (December 31, 1984 for FUTA purposes), but would have been included in the definition of wages on or before that date if the provisions of the Social Security Amendments of 1983 had applied on or before that date, is included in the definition of wages when the remuneration is paid, or, at the election of the payor, at the time which would be appropriate if such amendments had applied. Thus, for example, if an individual enters into a nonqualified deferred compensation arrangement after March 24, 1983, and before January 1, 1984, the Act provides that with respect to services performed before January 1, 1984, deferred amounts for which risk of forfeiture lapses during 1983 are included in wages for FICA tax purposes when the amounts are paid after December 31, 1983, unless the payor elects to treat them as wages paid during 1983. Of course, the grandfather rule for certain agreements in existence on March 24, 1983, still applies to insure that remuneration attributable to services performed before January 1, 1984, and paid under these agreements continues to be subject to prior law.

Second, the Act extends the grandfather rule to apply to agreements in existence on March 24, 1983, between an individual and a plan or employer, if the agreement provided for making payments upon retirement which would have been excluded from tax under prior law. Thus, under the Act, if such an agreement was in existence on that date, prior law is applicable with respect to remuneration attributable to services performed before January 1, 1984, for FICA purposes (before January 1, 1985, for FUTA purposes).

3. Codification of Rowan Decision (sec. 2662(g) of the Act, and secs. 3121 and 3306 of the Code)

Prior Law

The Social Security Amendments of 1983 provided that, with the exception of the value of certain meals and lodging provided for the convenience of the employer, the determination of whether or not amounts are includible in the social security and FUTA wage bases is to be made without regard to whether such amounts are treated in regulations as wages for income tax withholding purposes. This provision thus prevents the application to compensation, other than meals and lodging, of the Supreme Court's reasoning in *Rowan Companies, Inc. vs. United States*, 452 U.S. 247 (1981). In this case, the Supreme Court held that, because the treatment of certain employer meals and lodging (excluded from gross income under section 119) for income tax withholding and for FICA purposes was not explicitly dealt with in the statutes governing these provisions, Treasury regulations defining wages for purposes of these two provisions had to be consistent. Thus, because one Treasury regulation excluded from wages for income tax withholding purposes the value of meals and lodging excluded from gross income under section 119, another regulation including these amounts in wages for FICA purposes was held to be invalid.

The provision in the Amendments applies to remuneration paid after December 31, 1983, for FICA and social security benefit purposes and to remuneration paid after December 31, 1984, for FUTA purposes. Thus, it is possible that this provision could be cited as demonstrating Congressional intent that the reasoning of the *Rowan* decision should generally apply before these dates to types of remuneration other than meals and lodging excluded under section 119, e.g., to contributions under a salary reduction agreement to tax-sheltered annuities (sec. 403(b)). These contributions have been held by the Treasury Department to be taxable for FICA purposes (Revenue Ruling 65-208) even though they are exempt by regulation from income tax withholding.[10] If the 1965 revenue ruling were determined to be invalid, then employers and employees would be eligible for refunds for open years because taxable wages would be lower. In addition, wages for benefit computation purposes would be reduced, leading in some cases to reduction of social security benefits being paid to current beneficiaries and recoupment of a portion of benefits which have been paid in recent years on the basis of wage records which included the salary reduction contributions.

Explanation of Provision

In order to avoid the inferences which this provision could raise, the Act clarifies the effective date of the provision overriding the *Rowan* decision so that the provision applies for all purposes, other

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[10] The Social Security Amendments provide explicitly that contributions to tax-sheltered annuities under a salary reduction agreement are included in the wage base for social security and FUTA purposes, effective for remuneration paid after December 31, 1983 (December 31, 1984, for FUTA).

than the treatment of certain employer-provided meals and lodging, both to remuneration paid after March 4, 1983, and to remuneration paid on or before March 4, 1983, which the employer treated as wages when paid. For example, if an employer treated as wages, for FICA or FUTA taxes (or both), the amounts contributed during 1982 to an employee's tax-sheltered annuity pursuant to a salary reduction agreement, the FICA or FUTA taxes (as the case may be) paid by the employer and employee may not be refunded or credited. The Congress intends that the determination of whether an employer treated remuneration as wages when paid will be made on the basis of the interpretations reflected in section 3.02 of Rev. Proc. 78-35, 1978-2 C.B. 536 (relating to section 530 of the Revenue Act of 1978). In the event that FICA taxes are withheld or employment tax returns are filed as a result of an audit of prior periods by the IRS, the employer will still be considered to have treated the remuneration as wages when paid. Thus, the Congress did not accept and did not intend to adopt the contrary holding of *Ridgewell's, Inc.* v. *United States*, 655 F.2d 1098 (Ct. Cl., 1981).

4. Treatment of Social Security Benefits in Computing Credit for the Elderly and Disabled (sec. 2661(o)(1) of the Act and sec. 86(f) of the Code)

Prior Law

The credit for the elderly and permanently and totally disabled is equal to 15 percent of a base amount, which is reduced by amounts received of certain types of income (sec. 37). One such type of income is amounts received as a pension or annuity or disability benefit which is paid under title II of the Social Security Act and excluded from gross income. The section of the Social Security Amendments of 1983 dealing with the taxation of Social Security benefits contains a provision stating that social security benefits are to be treated as a pension or annuity for the purposes of certain Code sections, not including the credit for the elderly and disabled (sec. 86(f)).

Explanation of Provision

In order to remove any ambiguity as to the treatment of social security benefits in computing the credit for the elderly and disabled, the Act adds this credit to the list of provisions for which social security benefits are to be treated as an amount received as a pension or annuity.

APPENDIX:

ESTIMATED BUDGET EFFECTS OF REVENUE PROVISIONS OF THE ACT

Table 1.—Summary of Estimated Budget Effects of Revenue Provisions of the Act (H.R. 4170),

Fiscal Years 1984–1989

[Millions of dollars]

Title	Provision	1984	1985	1986	1987	1988	1989	1984–87
I.	Tax Freeze; Tax Reforms Generally	1,467	10,546	18,071	24,123	26,888	29,018	54,207
II.	Life Insurance Tax Provisions [1]	−80	−315	−375	−469	−541	−626	−1,239
III.	Private Foundation Provisions; Exempt Organizations		−33	−46	−47	−50	−53	−126
IV.	Tax Simplification Provisions	99	924	175	208	141	69	1,406
V.	Provisions Relating to Employers and Employees and to Retirement	31	149	265	274	296	336	719
VI.	Tax-Exempt Obligations	−73	−231	−359	−536	−756	−744	−1,199
VII.	Technical Corrections	(2)	(3)	(3)	(3)	(3)	(3)	(4)
VIII.	Foreign Sales Corporations		−62	−62	19	80	131	−105
IX.	Highway Revenue Provisions	−152	−102	19	−32	109	−21	−267
X.	Miscellaneous Revenue Provisions	−82	−268	−1,143	−1,067	−947	−874	−2,560
	Other Tax-Related Provisions	−67	−16	−12	−6	−9	−3	−101
	Total Revenue Effect	**1,143**	**10,592**	**16,533**	**22,467**	**25,211**	**27,233**	**50,735**

[1] The amounts represent the estimated effects of the life insurance tax provisions assuming that certain temporary provisions enacted in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), which provide for the taxation of life insurance companies, had been terminated. If these provisions had not been allowed to expire at the end of 1983, the estimates for the provisions in the bill would show increases in fiscal year receipts of $935 million in 1984, $1,050 million in 1985, $1,101 million in 1986, $1,192 million in 1987, and $1,291 million in 1988 (increase of $4,278 million for 1984–87).

[2] Gain of less than $5 million.

[3] Gain of less than $10 million.

[4] Amounts have not been assigned to footnotes for summation purposes. Therefore, totals do not include estimates represented by footnotes.

Table 2.—Estimated Budget Effects of Revenue Provisions of the Act (H.R. 4170), Fiscal Years 1984–1989

[Millions of dollars]

Provision	1984	1985	1986	1987	1988	1989	1984–87
Title I. Tax Freeze; Tax Reforms Generally							
A. Tax Freeze and Related Provisions							
Sec. 11—Postponement of increase in amount of used property eligible for investment tax credit		44	104	112	65		260
Sec. 12—Postponement of finance lease provisions	63	348	862	1,381	1,424	741	2,654
Sec. 13—Postponement of increases in amount of property eligible for expensing	230	399	433	386	−118	−427	1,448
Secs. 14, 541-545—Employee stock ownership credit		322	593	757	495	274	1,672
Sec. 15—Limits on contributions and benefits under qualified plans			17	64	106	115	81
Sec. 16—Net interest exclusion		1,024	2,858	3,100	3,366	3,637	6,982
Sec. 17—Postponement of increase in foreign earned income exclusion	4	31	80	106	107	79	221
Sec. 21—Defer scheduled reductions in maximum gift and estate tax rates		(2)	251	332	381	(2)	583
Sec. 25—Windfall profit tax rate on newly discovered oil		5					5
Sec. 26—Extension of excise tax on communications services			1,168	2,016	803		3,184

Sec. 27 (a) and (b)—Excise tax on distilled spirits		149	311	510	520	535	970
Sec. 27(c)—Modification of the manner of paying excise taxes on cigarettes and alcohol products		341	−52	5	5	5	294
Subtotal, tax freeze and related provisions	297	2,663	6,625	8,769	7,154	4,959	18,354
B. Leasing Provisions							
Sec. 31—Tax-exempt entity leasing	264	800	1,553	2,840	4,711	6,724	5,457
Sec. 32—Treatment of certain motor vehicle operating agreements as leases	(1)	(1)	(1)	(1)	(1)	(1)	(10)
Subtotal, leasing provisions	264	800	1,553	2,840	4,711	6,724	5,457
C. Treatment of Bonds and Other Debt Instruments (Secs. 41–44)							
Definitions and technical amendments							
Market discount and discount on short-term obligations	50	307	243	246	249	158	846
Original issue discount on tax-exempt bonds	3	5	7	8	10	13	23
Deferred payment transactions	(3)	218	660	1,184	1,730	2,302	2,062
Subtotal, debt instruments	53	530	910	1,438	1,989	2,473	2,931
D. Corporate Tax Provisions							
Sec. 51—Dividends received deduction for debt-financed portfolio stock	(3)	(3)	(3)	(3)	(3)	(3)	(10)

Table 2.—Estimated Budget Effects of Revenue Provisions of the Act (H.R. 4170), Fiscal Years 1984–1989—Continued

[Millions of dollars]

Provision	1984	1985	1986	1987	1988	1989	1984–87
Sec. 52—Certain dividends from regulated investment companies	2	5	5	5	5	5	17
Secs. 53–54—Treatment of certain distributions to corporate shareholders		140	100	100	100	100	340
Sec. 53(c)—Application of related party rules to various code provisions	(2)	(2)	(2)	(2)	(2)	(2)	(10)
Sec. 54—Nonliquidating distributions by corporations of appreciated property	2	14	48	101	160	222	165
Sec. 55—Capital gains distributed from regulated investment companies and real estate investment trusts			83	89	96	103	172
Sec. 56—Certain expenses incurred in connection with short sales	22	32	38	43	48	54	135
Sec. 57—Nonrecognition of gain or loss by corporations on options with respect to their stock (warrants)	(2)	(2)	(2)	(2)	(2)	(2)	(10)
Sec. 58—Accumulated earnings tax		62	78	33	35	36	173

Sec. 59—Repeal of stock for debt exception for purposes of determining income from discharge of indebtedness	(2)	(2)	(2)	(2)	(2)	(2)	(10)
Sec. 60—Affiliated groups		5	20	39	39	19	64
Sec. 61—Earnings and profits		109	283	270	289	278	662
Sec. 62—Net operating loss, etc. carryover rules	(5)	(5)	(5)	(5)	(5)	(5)	(10)
Sec. 63—Distribution requirements in the case of a "C" reorganization	(3)	(3)	(3)	(3)	(3)	(3)	(10)
Sec. 64—Control requirement in a "D" reorganization	(3)	(3)	(3)	(3)	(3)	(3)	(10)
Sec. 65—Collapsible corporations	5	57	196	305	351	382	563
Sec. 66—Phaseout of graduated rates for large corporations	70	212	185	190	192	194	657
Sec. 67—Golden parachute contracts	(2)	(2)	(2)	(2)	(2)	(2)	(10)
Sec. 68—Increase in reduction of certain corporate tax preference items from 15 percent to 20 percent		236	357	400	449	512	993
Subtotal, corporate provisions	101	872	1,393	1,575	1,764	1,905	3,941
E. Partnership Provisions							
Secs. 71-72—Shifting of income, gain, loss, and deduction when partnership interests change	4	111	222	278	340	398	615

Table 2.—Estimated Budget Effects of Revenue Provisions of the Act (H.R. 4170), Fiscal Years 1984–1989—Continued

[Millions of dollars]

Provision	1984	1985	1986	1987	1988	1989	1984–87
Uses of partnerships to change the character and timing of income, gain, loss or deduction:							
Sec. 73—Payments to partners for property or certain services		20	51	60	69	78	131
Sec. 74—Character of gain or loss on contributed property		24	63	66	67	69	153
Sec. 75—Transfers of partnership interests by corporations	(1)	50	50	50	50	50	150
Sec. 76—Use of tiered partnerships to alter character of income on exchanges of partnership interests	(1)	(1)	(1)	(1)	(1)	(1)	(10)
Sec. 77—Exchanges of like-kind property		82	362	667	788	842	1,111
Sec. 78—Use of tiered partnership to achieve step-up in basis of partnership assets	(1)	(1)	(1)	(1)	(1)	(1)	(10)
Sec. 79—Allocation of liabilities to limited partners	(11)	(11)	(11)	(11)	(11)	(11)	(10)
Subtotal, partnership provisions	4	287	748	1,121	1,314	1,437	2,160
F. Trust Provisions (Secs. 81–82)	50	237	390	436	464	488	1,113

G. Accounting Changes							
Sec. 91—Premature accruals [14]	138	429	510	491	399	373	1,568
Sec. 91—Prepaid expenses	108	243	76	93	112	133	520
Sec. 92—Deferred payments for use of property and services	43	258	486	654	846	887	1,441
Sec. 93—Capitalization of construction period interest and taxes		159	235	217	146	106	611
Sec. 94—Start-up expenses		23	36	31	26	19	90
Sec. 95—LIFO conformity		105	185	200	200	200	490
Subtotal, accounting changes	289	1,217	1,528	1,686	1,729	1,718	4,690
H. Tax Straddles (Secs. 101-108)	22	427	152	70	58	45	671
I. Depreciation and Related Provisions							
Sec. 111—Depreciation of real property	55	291	786	1,478	2,244	3,043	2,610
Sec. 112—Depreciation recapture and installment sales	24	56	212	219	224	234	511
Sec. 113—Movies	(3)	(3)	(3)	(3)	(3)	(3)	(10)
Sec. 113—Sound recordings	5	10	10	10	10	10	35
Sec. 114—Definition of new property for tax credit purposes	(1)	(1)	(1)	(1)	(1)	(1)	(10)
Subtotal, depreciation and related provisions	84	357	1,008	1,707	2,478	3,287	3,156
J. Foreign Provisions							
Sec. 121—Maintaining the source of U.S. source income	13	60	64	70	76	82	207
Sec. 122—Maintaining the character of interest income		67	118	129	142	157	314

Table 2.—Estimated Budget Effects of Revenue Provisions of the Act (H.R. 4170), Fiscal Years 1984-1989—Continued

[Millions of dollars]

Provision	1984	1985	1986	1987	1988	1989	1984-87
Sec. 123—Income from factoring trade receivables	([3])	306	534	576	622	673	1,416
Sec. 124—Source of transportation income	5	13	17	18	19	20	53
Sec. 125—Application of accumulated earnings tax to certain distributions received by U.S.-owned foreign corporations	([2])	([2])	([2])	([2])	([2])	([2])	([10])
Sec. 126—Extension of moratorium on application of research and experimental expense allocation regulation	−61	−127	−66				−254
Sec. 127—Repeal of 30-percent tax on portfolio interest paid to foreign persons	−2	−33	−65	−62	−40	−10	−162
Sec. 128—Original issue discount in the case of foreign investors	([1])	([1])	([1])	([1])	([1])	([1])	([10])
Sec. 129—Withholding on disposition by foreigners of U.S. real property	44	40	10	10	11	14	104
Sec. 130—Use of territories to avoid U.S. tax on foreign investors	([3])	([3])	([3])	([3])	([3])	([3])	([10])
Sec. 131—Taxation of certain transfers of property outside the United States			12	127	324	540	139

Sec. 132—Amendments relating to foreign personal holding companies	(2)	(2)	(2)	(2)	(2)	(2)	(10)
Sec. 133—Gain from sale or exchange of stock in certain foreign corporations	(3)	(3)	(3)	(3)	(3)	(3)	(10)
Sec. 133—Ordinary income treatment on disposition of stock of certain foreign corporations under Code section 1248	(2)	(2)	(2)	(2)	(2)	(2)	(10)
Sec. 134—Foreign investment companies	(3)	(3)	(3)	(3)	(3)	(3)	(10)
Sec. 135—Foreign collapsible corporations	(3)	(3)	(3)	(3)	(3)	(3)	(10)
Sec. 136—Stapled stock; stapled entities	(2)	(2)	(2)	(2)	(2)	(2)	(10)
Sec. 137—Insurance of related parties by a controlled foreign corporation	26	44	46	49	51	54	165
Sec. 138—Definition of resident alien	5	10	10	10	10	10	35
Sec. 139—Treatment of community property income of nonresident aliens	2	5	5	5	5	5	17
Subtotal, foreign provisions	32	385	685	932	1,220	1,545	2,034
K. Compliance Provisions							
Secs. 141-144—Provisions relating to tax shelters		26	30	28	24	20	84
Secs. 145-152—Information reporting provisions		20	92	175	232	255	287

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Table 2.—Estimated Budget Effects of Revenue Provisions of the Act (H.R. 4170), Fiscal Years 1984–1989—Continued

[Millions of dollars]

Provision	1984	1985	1986	1987	1988	1989	1984–87
Secs. 155–163—Other compliance provisions		11	48	53	56	58	112
Subtotal, compliance provisions		57	170	256	312	333	483
L. Miscellaneous Reform Provisions							
Sec. 171—Tax benefit rule		229	253	274	300	330	756
Sec. 172—Interest-free and below-market interest rate loans	44	136	167	188	211	237	535
Sec. 173—Modification of income averaging	133	1,994	1,886	2,053	2,226	2,404	6,066
Sec. 174—Treatment of certain related party transactions	46	109	176	253	346	416	584
Sec. 175—Transfers of depreciable property between related parties	([2])	([2])	([2])	([2])	([2])	([2])	([10])
Sec. 176—Losses on sales and exchanges of property used in a trade or business		27	75	99	131	173	201
Sec. 177—Taxation of the Federal Home Loan Mortgage Corporation		67	109	142	185	240	318
Sec. 178—Use of multicompany structure to reduce tax on coal operations		2	10	15	17	18	27

Sec. 179—Limitations with respect to property which is partially used for personal purposes and luxury automobiles	48	150	233	269	279	286	700
Subtotal, miscellaneous reform provisions	271	2,714	2,909	3,293	3,695	4,104	9,187
Total, tax freeze; tax reforms generally	**1,467**	**10,546**	**18,071**	**24,123**	**26,888**	**29,018**	**54,207**
Title II. Life Insurance Tax Provisions [6]	**−80**	**−315**	**−375**	**−469**	**−541**	**−626**	**−1,239**
Title III. Private Foundation Provisions							
Sec. 301—Nonoperating (grant-making) foundations		−10	−17	−18	−21	−24	−45
Sec. 302-310, 312-314—Other private foundation provisions		−23	−29	−29	−29	−29	−81
Sec. 311—Exemption from UBIT for certain gambling income	(7)	(7)	(7)	(7)	(7)	(7)	(10)
Total, private foundations, etc.		**−33**	**−46**	**−47**	**−50**	**−53**	**−126**
Title IV. Tax Simplification Provisions							
A. Individual Estimated Tax (Secs. 411-414)		746	−6	−9	−15	−21	731
B. Domestic Relations							
Sec. 421—Treatment of transfer of property between spouses or incident to divorce	(4)	(4)	(4)	(4)	(4)	(4)	(10)
Sec. 422—Alimony		2	12	33	57	77	47
Secs. 423, 426—Dependency exemption	(1)	(1)	(1)	(1)	(1)	(1)	(10)

Table 2.—Estimated Budget Effects of Revenue Provisions of the Act (H.R. 4170), Fiscal Years 1984–1989—Continued

[Millions of dollars]

Provision	1984	1985	1986	1987	1988	1989	1984–87
Sec. 424—Innocent spouse relieved of liability in certain cases	(1)	(1)	(1)	(1)	(1)	(1)	(10)
Sec. 425—Gift and estate tax liability for transfers of property to spouses incident to divorce	(1)	(1)	(1)	(1)	(1)	(1)	(10)
Subtotal, domestic relations		2	12	33	57	77	47
C. At-risk Provisions (Secs. 431–432)	(1)	(1)	(1)	(1)	(1)	(1)	(10)
D. Administrative Provisions							
Secs. 441–449—Miscellaneous Treasury administrative provisions	(1)	(1)	(1)	(1)	(1)	(1)	(10)
Sec. 450—Financial accounting for the investment tax credit							
Sec. 451—Distilled spirits administrative provisions	(1)	(1)	(1)	(1)	(1)	(1)	(10)
Subtotal, administrative provisions	(1)	(1)	(1)	(1)	(1)	(1)	(10)
E. Tax Court Provisions							
Sec. 461—Tax Court Commissioners and jurisdictional limit for small tax cases							

Sec. 462—Annuities for survivors of Tax Court Judges	(9)	(9)	(9)	(9)	(9)	(9)	(10)
Sec. 463—Publicity of Tax Court proceedings							
Subtotal, Tax Court provisions	(9)	(9)	(9)	(9)	(9)	(9)	(10)
F. Simplification of Income Tax Credits (Secs. 471-475)	100	183	179	194	110	25	656
G. Miscellaneous Simplification							
Sec. 481—Preferred stock eligible under section 1244	(4)	(4)	(4)	(4)	(4)	(4)	(10)
Sec. 482—Medical expense deduction for certain lodging	−1	−7	−10	−10	−11	−12	−28
Subtotal, miscellaneous simplification	−1	−7	−10	−10	−11	−12	−28
H. Deadwood (Secs. 491-492)							
Total, tax simplification	**99**	**924**	**175**	**208**	**141**	**69**	**1,406**
Title V. Provisions Relating to Employers and Employees and to Retirement							
A. Welfare Benefit Plans (Secs. 511-513; 561)[13]	63	188	217	222	242	280	690
B. General Pension Plan Provisions							
Secs. 521-522—Distribution rules of qualified pension plans	(2)	(2)	(2)	(2)	(2)	(2)	(10)

Table 2.—Estimated Budget Effects of Revenue Provisions of the Act (H.R. 4170), Fiscal Years 1984–1989—Continued

[Millions of dollars]

Provision	1984	1985	1986	1987	1988	1989	1984–87
Sec. 523—Treatment of distributions of benefits substantially all of which are derived from employee contributions	(1)	1	2	2	4	6	5
Sec. 524—Provisions relating to top-heavy plans	(5)	(5)	(5)	(5)	(5)	(5)	(10)
Sec. 525—Repeal of estate tax exclusion for qualified plan benefits			50	50	50	50	100
Secs. 526, 713—Affiliated service groups, employee leasing arrangements, and collective bargaining agreements	(1)	(1)	(1)	(1)	(1)	(1)	(10)
Sec. 527—Standards for cash-or-deferred arrangements	(1)	(1)	(1)	(1)	(1)	(1)	(10)
Sec. 528—Treatments of certain medical, etc., benefits under pension plans	(3)	(3)	(3)	(3)	(3)	(3)	(10)
Sec. 529—Alimony treated as compensation for IRA purposes	(4)	(4)	(4)	(4)	(4)	(4)	(10)
Subtotal, general pension plans		1	52	52	54	56	105

C. Fringe Benefits							
Secs. 531(a), 531(c)-(g)—Exclusion for certain employer provided fringe benefits; moratorium	(1)	(1)	(1)	(1)	(1)	(1)	(10)
Sec. 531(b)—Cafeteria plans	−32	−40	−4				−76
Sec. 532—Qualified tuition reduction	(1)	(1)	(1)	(1)	(1)	(1)	(10)
Subtotal, fringe benefits	−32	−40	−4	(1)	(1)	(1)	−76
D. Employee Stock Ownership Provisions (Secs. 541-545)		(15)	(15)	(15)	(15)	(15)	(15)
E. Miscellaneous Benefit Provisions							
Sec. 551—Treatment of certain distributions from a qualified termination plan	(1)	(1)	(1)	(1)	(1)	(1)	(10)
Sec. 552—Special rule for Trans-Alaskan Pipeline emloyees	(1)	(1)	(1)	(1)	(1)	(1)	(10)
Sec. 553—Distribution requirements for plans, accounts, and annuities of an insurer in rehabilitation proceedings	(1)	(1)	(1)	(1)	(1)	(1)	(10)
Sec. 554—Extension of time for repayment of qualified refunding loans	(1)	(1)	(1)	(1)	(1)	(1)	(10)
Sec. 555—Incentive stock options	(1)	(1)	(1)	(1)	(1)	(1)	(10)
Sec. 556—Certain section 83(b) elections	(1)	(1)	(1)	(1)	(1)	(1)	(10)
Sec. 557—Employee and welfare benefit fund treated as related persons	(1)	(1)	(1)	(1)	(1)	(1)	(10)

Table 2.—Estimated Budget Effects of Revenue Provisions of the Act (H.R. 4170), Fiscal Years 1984-1989—Continued

[Millions of dollars]

Provision	1984	1985	1986	1987	1988	1989	1984-87
Sec. 558—Elimination of retroactive application of amendments made by Multiemployer Pension Plan Act of 1980	(1)	(1)	(1)	(1)	(1)	(1)	(10)
Sec. 559—Pension portability involving telecommunications divestiture	(1)	(1)	(1)	(1)	(1)	(1)	(10)
Subtotal, miscellaneous benefits	(1)	(1)	(1)	(1)	(1)	(1)	(10)
Total, provisions relating to employers and employees, etc	**31**	**149**	**265**	**274**	**296**	**336**	**719**
Title VI. Tax-Exempt Obligations							
Secs. 611-614—Mortgage subsidy bonds and mortgage credit certificates	−48	−217	−498	−810	−1,017	−1,000	−1,573
Secs. 611(d)(5), 621-632, 641-645, 647, 648—Private activity bonds; misc. provisions	−25	−14	139	274	261	256	374
Total, tax-exempt obligations	**−73**	**−231**	**−359**	**−536**	**−756**	**−744**	**−1,199**
Title VII. Technical Corrections	(2)	(3)	(3)	(3)	(3)	(3)	(10)
Title VIII. Foreign Sales Corporations		**−62**	**−62**	**19**	**80**	**131**	**−105**

Title IX. Highway Revenue Provisions							
Secs. 901–903—Reduction in heavy vehicle use tax and increase in diesel fuel tax	−152	−51	84	37	183	52	−82
Secs. 914, 935—One-year extension of refund of taxes on fuels used by taxicabs		−2	(1)				−2
Secs. 921, 936—Excise tax exemption for certain piggy-back trailers		−5					−5
Secs. 912, 913—Increase in excise tax exemptions for alcohol fuels mixtures and alcohol fuels; income tax credit for qualified alcohol fuels; and duty on imported alcohol fuels		−44	−65	−69	−74	−73	−178
Total, highway revenue provisions	**−152**	**−102**	**19**	**−32**	**109**	**−21**	**−267**
Title X. Miscellaneous Revenue Provisions							
A. Capital Gains and Losses (Secs. 1001–1002)	(5)	(5)	−279	−268	−286	−280	−547
B. Excise Tax Provisions							
Secs. 1010–1016—Excise tax on sport fishing equipment		12	13	14	14	15	39
Sec. 1017—Excise tax on certain arrows		(1)	(1)	(1)	(1)	(1)	(10)
Sec. 1018—Exemption of certain helicopter operations from aviation excise taxes	−3	−4	−4	−5	−2		−16
Sec. 1019—Superfund excise tax corrections							
Subtotal, excise tax provisions	−3	8	9	9	12	15	23

Table 2.—Estimated Budget Effects of Revenue Provisions of the Act (H.R. 4170), Fiscal Years 1984–1989—Continued

[Millions of dollars]

Provision	1984	1985	1986	1987	1988	1989	1984–87
C. Estate and Gift Tax Provisions							
Sec. 1021—Qualification of certain holding company stock for installment payment of estate tax	(4)	−13	−19	−24	−29	−36	−56
Sec. 1022—Reformation of certain charitable split-interest trusts	(4)	(4)	(4)	(4)	(4)	(4)	(10)
Secs. 1023–1024—Alternate valuation date election		10	10	10	10	10	30
Sec. 1025—Perfection of estate tax current use valuation elections	(1)	(1)	(1)	(1)	(1)	(1)	(10)
Sec. 1026—No gain recognized from net gifts made before March 4, 1981	(4)	(4)	(4)	(4)	(4)	(4)	(10)
Sec. 1027—Clarification that certain usufruct interests qualify for estate tax marital deduction	(4)	(4)	(4)	(4)	(4)	(4)	(10)
Sec. 1028—Special estate tax credits	−22						−22
Subtotal, estate and gift provisions	−22	−3	−9	−14	−19	−26	−48

D. Charitable Contributions and Exempt Organizations							
Sec. 1031—Charitable expense deduction for use of passenger automobile		−5	−37	−43	−51	−60	−85
Sec. 1032—Tax treatment of certain non-profit child care organizations	(4)	(4)	(4)	(4)	(4)	(4)	(10)
Sec. 1033—Church inquiries and examinations	(1)	(1)	(1)	(1)	(1)	(1)	(10)
Sec. 1034—Acquisition indebtedness of certain educational institutions	−24	−46	−58	−73	−91	−114	−201
Sec. 1035—Expansion of circumstances in which a deduction may be claimed for a qualified conservation contribution	(4)	−5	−5	−5	−5	−5	−15
Subtotal, charitable contributions and exempt organizations	−24	−56	−100	−121	−147	−179	−301
E. Income Tax Credits							
Sec. 1041—Extension of targeted jobs tax credit		−147	−380	−308	−160	−93	−835
Sec. 1042—Earned income credit [8]		−13	−373	−342	−315	−290	−728
Sec. 1043—Alternative test for definition of qualified rehabilitated building	(1)	(1)	(1)	(1)	(1)	(1)	(10)
Subtotal, income tax credits		−160	−753	−650	−475	−383	−1,563
F. Miscellaneous Housing Provisions							
Sec. 1051—Disaster loss deduction for condemned residences	−15	−12	−12	−13	−13	−14	−52

Table 2.—Estimated Budget Effects of Revenue Provisions of the Act (H.R. 4170), Fiscal Years 1984-1989—Continued

[Millions of dollars]

Provision	1984	1985	1986	1987	1988	1989	1984-87
Sec. 1052—Deductibility of mortgage interest and taxes paid out of tax-free allowances for ministers	....	(4)	(4)	....	....	....	....
Sec. 1053—Rollover of gain on sale of residence for military personnel stationed overseas	(1)	−5	−5	−5	−5	−5	−15
Sec. 1054—Treatment of home won in local radio contest and specially designed for handicapped foster child	(1)	(1)	(1)	(1)	(1)	(1)	(10)
Subtotal, miscellaneous housing provisions	−15	−17	−17	−18	−18	−19	−67
G. Extensions and Miscellaneous Transition Rules							
Sec. 1061—Extension of the Payment-in-Kind Tax Treatment Act of 1983	−7	−8	15	(1)	(1)	(1)	(10)
Sec. 1062—Reinstatement of deduction for elimination of certain barriers to the handicapped and the elderly	−8	−16	−7	....	....	....	−31

Sec. 1063—Disallowance of deduction for costs of demolishing structures	(2)	(2)	(2)	(2)	(2)	(2)	(10)
Sec. 1064—Amortization of low-income housing rehabilitation expenditures	−2	−7	−18	−32	−43	−34	−59
Sec. 1065—Provisions of Indian Tribal Government Tax Status Act of 1982 made permanent	(4)	(4)	(4)	(4)	(4)	(4)	(10)
Sec. 1066—Investment income from S corporations	(1)	(1)	(1)	(1)	(1)	(1)	(10)
Sec. 1067—Transitional rule for safe-harbor leasing of coal gasification facilities		−8	−2	−1	−1	(1)	−11
Subtotal, extensions and transitions	−17	−39	−12	−33	−44	−34	−101
H. Additional Provisions							
Sec. 1071—Tax treatment of regulated investment companies	(1)	(1)	(1)	(1)	(1)	(1)	(10)
Sec. 1072—Employee tips	(1)	(1)	(1)	(1)	(1)	(1)	(10)
Sec. 1073—FUTA treatment of tips			18	28	30	32	46
Sec. 1074—FUTA treatment of certain fishing activities	−1	−1					−2
Sec. 1075—Taxation of unemployment compensation for pre-1978 periods	(7)	(7)					(10)
Sec. 1076—Exclusion from gross income for cancellation of certain student loans	(4)	(4)	(4)	(4)	(4)	(4)	(10)
Sec. 1077—Duck stamps	(1)	(1)	(1)	(1)	(1)	(1)	(10)

Table 2.—Estimated Budget Effects of Revenue Provisions of the Act (H.R. 4170), Fiscal Years 1984-1989—Continued

[Millions of dollars]

Provision	1984	1985	1986	1987	1988	1989	1984-87
Sec. 1078—Boundary Waters Canoe Act payments	(1)	(1)					
Subtotal, additional provisions	−1	−1	18	28	30	32	44
Total, miscellaneous revenue provisions	**−82**	**−268**	**−1,143**	**−1,067**	**−947**	**−874**	**−2,560**
Other Tax-Related Provisions [12]							
Sec. 2603—Social security treatment of certain church employees	−67	−16	−12	−6	−9	−3	−101
Sec. 2813(a)—Tax exemption for the National Credit Union Administration Central Liquidity Facility	(4)	(4)	(4)	(4)	(4)	(4)	(10)
Subtotal, other tax-related provisions	**−67**	**−16**	**−12**	**−6**	**−9**	**−3**	**−101**
Total Revenue Effect	**1,143**	**10,592**	**16,533**	**22,467**	**25,211**	**27,233**	**50,735**

[1] Negligible.
[2] Gain of less than $5 million.
[3] Gain of less than $10 million.
[4] Loss of less than $5 million.
[5] Loss of less than $10 million.
[6] The amounts represent the estimated effects of the life insurance tax provisions assuming that certain temporary provisions enacted in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), which provide for the taxation of life insurance companies, had been terminated. If these provisions had not been allowed to expire at the end of 1983, the estimates for the provisions in the bill would show

increases in fiscal year receipts of $935 million in 1984, $1,050 million in 1985, $1,101 million in 1986, $1,192 million in 1987, and $1,291 million in 1988.

[7] Loss of less than $1 million.

[8] The changes to the earned income credit will reduce revenues by $4 million in 1985, $116 million in 1986, $105 million in 1987, $98 million in 1988 and $90 million in 1989, and increase outlays by $9 million in 1985, $257 million in 1986, $237 million in 1987, $217 million in 1988, and $200 million in 1989.

[9] Increases budget outlays by a negligible amount.

[10] Amounts have not been assigned to footnotes for summation purposes. Therefore, totals do not include estimates represented by footnotes.

[11] Included in other partnership provisions.

[12] These items appear in the Spending Reduction Act of 1984 (Division B of the Deficit Reduction Act of 1984). However, because there are revenue effects associated with the provisions, they are included in the revenue tables.

[13] This includes amounts attributable to changes in the treatment of accrued vacation pay.

[14] This includes the effects of this section associated with the decommissioning of nuclear power plants and with the reclamation of mines.

[15] The revenue effect of Title V—D is included with the estimates for Title I, sec. 14,. "Employee Stock Ownership Credit."