[JOINT COMMITTEE PRINT]

PROPOSALS RELATING TO TAX SHELTERS AND OTHER TAX-MOTIVATED TRANSACTIONS

SCHEDULED FOR HEARINGS

BEFORE THE

COMMITTEE ON WAYS AND MEANS

ON FEBRUARY 22 AND 28, 1984

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

FEBRUARY 17, 1984

U.S. GOVERNMENT PRINTING OFFICE

30-741 O WASHINGTON : 1984 JCS-5-84

Errata Sheet for Joint Committee Print JCS-5-84 (Feb. 17, 1984), "Proposals Relating to Tax Shelters and Other Tax-Motivated Transactions"

On page 9, the extreme right-hand column of numbers in Table 1 should be headed "Net loss" and the numbers in the column should be preceded by a minus sign (e.g., the total should be -$36.813).

On page 9, footnote 4, the second sentence of the footnote should be deleted.

On page 27, the fifth line of the first full paragraph should read: cost recovery deductions and $100 of cost recovery deductions could be allocated by

On page 45, the reference on the fifth line of the first full paragraph should read: section 1.b, above.

On page 60, the heading "Computation of interest in deferred payment transactions" should appear immediately after the heading "Present Law and Background".

On page 71, the footnote sign "42" should appear at the end of the third full paragraph, after the word "December."

On page 89, the word "Administration" should be deleted from the heading over the last paragraph and from the first line of the last paragraph.

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INTRODUCTION

The House Committee on Ways and Means has scheduled public hearings on February 22 and 28, 1984, on the Administration's proposals relating to tax shelters, accounting abuses, and corporate reforms, as well as related proposals to be included in this pamphlet. The February 1, 1984, announcement of those hearings referred to various proposals for dealing with tax shelters and other tax-motivated transactions, and stated that proposals would be described in a hearing pamphlet to be made available before the Administration's testimony on February 22. This pamphlet contains those descriptions, and, in addition, provides general background information on tax-motivated transactions.

I. SUMMARY

This pamphlet deals with a variety of tax-motivated transactions and describes proposals to address areas of the law which make these transactions possible. Many tax-motivated transactions fall under the heading of "tax shelters." Tax-shelter investments enable taxpayers to reduce their tax liabilities by use of tax benefits generated by the investments. There are three selling points common to most tax-shelter investments: (1) the ability to defer tax liability to a later year; (2) the opportunity to convert ordinary income to tax-favored income (such as capital gains); and (3) the use of borrowed funds to finance the investment (leverage). The elements of a tax-shelter investment are described in Part II. Part III is a brief economic analysis of tax shelters.

Beginning in 1969, Congress has enacted a series of income tax laws that were designed to reduce the use of abusive tax shelters. Part IV contains brief summaries of tax-shelter provisions contained in the Tax Reform Act of 1969, the Revenue Act of 1971, the Tax Reform Act of 1976, the Economic Recovery Tax Act of 1981, and the Tax Equity and Fiscal Responsibility Act of 1982.

Certain aspects of present law continue to provide taxpayers with opportunities to obtain possibly unintended tax benefits. For example, the benefits of deferring a tax liability are attributable, in large part, to the fact that present law does not take adequate account of the present value of a future expense or receipt. Other identified unintended benefits under present law include (1) the use of partnerships to achieve tax results not otherwise available, (2) the use of generally available deductions (*e.g.*, interest) to offset unrelated income, (3) the overvaluation of property that is used to generate tax deductions (*e.g.* charitable contributions), and (4) the organization of foreign corporations to avoid the current U.S. tax. Part V describes various tax-motivated transactions and the tax rules related to them. It then presents proposals to address these transactions, including the proposals made by the Administration in its budget. Some of these transactions can be described as tax shelters; in others, there is no tax shelter as such, but a tax motivation dominates the transaction; in still other cases, the tax motivation may be secondary but the tax benefits arising from the transaction exceed what was originally intended by Congress when the relevant provisions of law were drafted. Part V also addresses compliance questions related to tax shelters and, in a final section, some miscellaneous revenue-raising proposals.

II. OVERVIEW OF TAX SHELTERS

Many of the tax-motivated transactions addressed in this pamphlet are commonly known as tax shelters. This section discusses some of the features of tax shelters.

A. THE NATURE OF A TAX-SHELTER INVESTMENT

In general, a tax shelter is an investment in which a significant portion of the investor's return is derived from the realization of tax savings with respect to other income, as well as the receipt of tax-favored (or, potentially, tax-exempt) income from the investment itself. Generally, tax shelters are passive investments in the sense that the investor is not involved in actively managing a business. Tax shelters are typically characterized as abusive if they are structured to give the investor larger tax benefits than may be warranted under present law, or to take advantage of uncertainties in the law primarily to obtain tax benefits, without regard to the economic viability of the investment.

In some instances, tax shelters take advantage of specific incentives, such as the accelerated cost recovery system or the deduction for intangible drilling costs, which Congress has legislated. Other shelters use devices in the tax law to achieve tax savings which were never specifically intended by Congress. Still others inflate certain deductions, credits, etc. beyond the properly allowable amount.

B. THE ELEMENTS OF A TAX SHELTER

Although tax-shelter investments take a variety of forms, there are several elements that are common to most tax shelters. The first of these is the "deferral" of tax liability to future years, resulting, in effect, in an interest-free loan from the Federal Government. The second element of a tax shelter is the "conversion" of ordinary income (subject to tax at a maximum rate of 50 percent for individuals) to tax-favored income (such as capital gains subject to tax at a maximum rate of 20 percent). Finally, many tax shelters permit a taxpayer to leverage his investment (*i.e.*, to use borrowed funds to pay deductible expenditures), thereby maximizing the tax benefit of deductibility. These elements of a tax shelter are described below.[1]

1. Deferral

Deferral generally arises from the acceleration of deductions to reduce a taxpayer's tax liability in the early years of an investment so that income is concentrated in the later years Deferral also occurs when, for example, taxpayers funnel U.S. investments

[1] The elements of a tax shelter investment are fully described in the pamphlet "Overview of Tax Shelters" (JCS-22-75), published in 1975 by the staff of the Joint Committee on Taxation.

through a foreign corporation the earnings of which are not subject to current U.S. tax.

The effect of deferral is that the taxpayer grants himself an interest-free loan from the Federal Government, which loan is repayable when the tax-shelter investment either produces taxable income or is disposed of at a gain. For example, if at the end of year one, a taxpayer wishes to have an additional loan for use in year two, he can obtain a one-year loan when the prevailing rate of interest is 15 percent (compounded annually), and repay $1,150 at the end of year two. Alternatively, the taxpayer could invest in a tax shelter that deferred tax on $2,000 of income until the following year. The taxpayer would have a $1,000 tax savings (at the 50-percent maximum rate of tax). In the latter case, at the end of year two, instead of repaying a lender $1,150 at an after tax cost of $1,075, the taxpayer would incur a Federal income tax of $1,000 on the $2,000 of income generated by the investment. Obviously, the longer the deferral period, the greater the benefit obtained by the taxpayer. In addition, the taxpayer could invest in another tax shelter to provide a "rollover" or further deferral of the tax.

In some cases, deferral is obtained by the use of legislatively sanctioned tax benefits, such as, for example, the Accelerated Cost Recovery System (ACRS) or the expensing of intangible drilling costs. Other benefits associated with deferral reflect the tax law's treatment of the time value of money, and are discussed at length in Part V. below.

2. Conversion of Ordinary Income

The second aspect of most tax-shelter investments is the "conversion" of ordinary income to tax-favored income (such as capital gains or income that is otherwise subject to a reduced rate of tax). Conversion is achieved when, for example, a taxpayer takes an accelerated deduction against ordinary income and receives income from the investment that is taxed at the 20-percent maximum capital gains rate. Also, if the taxpayer is in a lower tax bracket in the year when the investment generates income, he effectively "converts" the tax rate. Corporations benefit from converting ordinary income to dividend income eligible for the 85-percent dividends received deduction.

In the case of certain deductions (*e.g.*, depreciation deductions), as described in Part IV below, Congress has dealt with conversion by requiring a portion of the gain on disposition of an investment to be treated as ordinary income (rather than capital gains). However, the current recapture rules apply only to prevent the conversion of some ordinary income to capital gains, and do not apply to all tax shelters.

3. Leverage

The use of borrowed money to fund a tax-shelter investment may result in an economic benefit, as well as a tax benefit. Generally, a taxpayer will borrow an amount of money that equals or exceeds his equity investment. From an economic viewpoint, to the extent that a taxpayer can use borrowed money to fund a tax-shelter investment, he can use his own money for other purposes (such as other investments), resulting in an increase in earnings if the investments are profitable. From a tax viewpoint, borrowed funds generally are treated in the same manner as a taxpayer's own money. Because a taxpayer is allowed deductions for expenditures paid with borrowed funds, the tax benefits of deductibility (*e.g.*, deferral) are maximized.

Because interest payments on indebtedness are themselves deductible, a debt-financed investment provides an additional tax advantage relative to an equity-financed investment. This is so because the deductibility of interest payments lowers the effective tax rate[2] on the income generated by the investment.

The benefits of leveraging a tax-shelter investment can be illustrated by a simple example. Assume that a 50-percent bracket taxpayer invests $10,000 of his own money, and borrows $90,000 to fund a $100,000 investment. If the investment generates a "tax loss" of $30,000 in the first year by reason of accelerated deductions, the taxpayer will save taxes of $15,000 on his investment of $10,000.

The significance of leverage increases where a taxpayer obtains a nonrecourse loan (i.e., when there is no personal liability to repay the loan). The benefits associated with the use of nonrecourse loans are discussed below.

To some extent, the tax benefits arising from interest deductions are offset by the tax paid on the lender's interest income. However, many lenders are tax-exempt, and taxable lenders tend to have lower marginal tax rates than do borrowers. As a result, debt financing tends to result in revenue losses to the Treasury.

C. SCOPE OF TAX SHELTER CASES

According to an industry newsletter, taxpayers invested approximately $8.4 billion in "public program" tax-advantaged investments (i.e, limited partnerships registered with the Securities and Exchange Commission) in 1983, compared to approximately $5.5 billion in 1982.[3] The largest increases from 1982 to 1983 were in real estate investments and investments in income-producing oil and gas properties. Many of these investments represented real capital formation for the economy; however, the data are indicative of the increasing use of abusive tax shelters as well. The flourishing of tax shelters in recent years has affected the administration of the tax laws in three ways. First, the limited audit resources of the Internal Revenue Service have increasingly been diverted to focus on tax shelters. Second, the judicial process, particularly the Tax Court, has been burdened by a substantial increase in the number of pending cases. Third, the rise of the tax-shelter industry may have contributed significantly to the general deterioration in compliance by undermining taxpayer confidence in the fairness and effectiveness of the tax laws.

With respect to audit resources, resource constraints on the Internal Revenue Service have combined with growth in the number

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[2] The effective tax rate on income derived from an investment is the amount of tax paid per dollar of income earned. The concept of an "effective tax rate" is explained more fully in the pamphlet "Analysis of Proposals for Depreciation and Investment Tax Credit Revisions, Part I: Overview" (JCS-18-81), published in 1981 by the staff of the Joint Committee on Taxation.

[3] Robert A. Stanger & Co., *The Stanger Report*, February 1984.

of taxpayers to reduce audit coverage from 2.11 percent of all individual income tax returns in 1979 to 1.50 percent in 1983. In 1979, the Internal Revenue Service examined 1,844,986 individual income tax returns. By 1982, that number had declined to 1,427,660 returns. At the same time the number of staff positions assigned to examination went from 22,911 to 24,071. At the end of 1983, there were 334,549 tax shelter cases in audit as compared with 182,731 at the end of 1979. During 1983, another 95,998 tax shelter cases were closed after examination with recommended taxes and penalties of $1.8 billion. Thus, although the closed tax shelter cases represented only 7 percent of examined cases, they accounted for 46 percent of the recommended taxes and penalties.

The increasing number of tax shelter returns has also contributed to the rising backlog of cases in the Tax Court. At the end of 1979, the Tax Court had 27,910 cases pending on its docket. In 1981, three additional judges were appointed to the Tax Court and the interest rate on deficiencies was increased. Also, between 1979 to 1983, the Tax Court more than doubled the rate at which it disposed of cases, closing almost 28,620 in 1983 as compared to 13,098 in 1979. Nonetheless, by the end of 1983, the backlog of docketed cases had risen to 57,869 cases. Approximately 20,000 of these cases (representing asserted deficiencies of $1.4 billion) were tax shelter cases.

Although the direct impact of tax shelters on the administrative and judicial process as quantified above is substantial, their indirect impact may be more significant. A major concern is that the highly visible marketing of tax shelters, and the accompanying belief that the Internal Revenue Service cannot deal with them, may erode taxpayers' confidence in the fairness and effectiveness of the tax system. Sociological research supports the proposition that taxpayers are more likely to comply with the tax laws when they perceive the system to be fair or when the costs of noncompliance are perceived as relatively high and relatively certain. The widespread use of tax shelters deprives the system of its claim to fairness and retards the administrative and judicial processes to the point that penalties seem neither certain nor costly.

III. ECONOMIC ANALYSIS

Overview

The increase in tax shelter activity has an immediate impact on tax revenue, particularly in the case of "abusive" shelters where the tax write-offs are several times larger than the equity investment. This increases the budget deficit. Furthermore, the proliferation of tax shelter activity may decrease public confidence in the equity of the tax system. In addition, the organization and promotion of tax shelters diverts thousands of lawyers, accountants, and other professionals from other, possibly more productive activities.

Limited Partnership Tax Shelters

Generally speaking, a tax shelter is any investment which results in a mismatch between deductions (or credits) and income, so that the deductions (or credits) "shelter" unrelated income from tax. For purposes of analysis it is useful to distinguish between tax shelter benefits that arise from tax incentives provided by Congress and those that result from the creative use of structural tax rules to accomplish results not intended by Congress. A so-called abusive tax shelter is structured to give the investor larger write-offs than may be warranted under current law or take advantage of uncertainties under the law. Abusive tax shelters may constitute tax evasion rather than avoidance, and sometimes involve fraudulent overvaluation of assets.

Increasingly, the limited partnership form of organization has been used to take advantage of tax shelters. Limited partnerships, like corporations, limit the liability of investors, but unlike corporations, are not subject to the corporate income tax. The income or loss of partnerships is flowed-through and taxed at the partner level. In 1980, partnerships (both limited and general) reported net losses of over $1 billion dollars in six sectors: farming, oil and gas extraction, security and commodity dealers, holding and investment companies, real estate, and business services (including leasing). Table 1 shows that half of the $36.8 billion of business losses claimed by partners is attributable to two sectors: real estate ($11.4 billion) and oil and gas extraction ($7.2 billion).

Table 1. Partnership Income, 1980

[Dollar amounts in billions]

Sector	With Net Income: Number of partnerships (thousand)	With Net Income: Net income	Without Net Income: Number of partnerships (thousand)	Without Net Income: Net income
Total	774	$45.062	606	$36.813
Farms	63	2.239	45	1.813
Oil and gas extraction	14	3.577	17	7.271
Security/commodity dealers	1	.591	1	1.070
Holding/investment companies	92	5.831	69	6.876
Real estate	211	8.125	253	11.412
Leasing and business services	29	1.168	22	1.104

Source: Internal Revenue Service, *Statistics of Income—1980, Partnership Returns,* Table 1.

The use of tax-shelter investments by higher bracket taxpayers became increasingly widespread through the 1970s. In 1979, 39 percent of taxpayers with over $200,000 of adjusted gross income (AGI), before partnership loss, reported net partnership losses, which reduced federal income tax liability by 10.7 percent in this income class. Considering just those taxpayers in the top income bracket reporting partnership loss, these losses reduced their tax liability by an average 25.2 percent. On the other hand, only 0.1 percent of taxpayers with pre-loss AGI of $10-$20 thousand reported net partnership loss, and this loss reduced tax liability by only 0.2 percent in this income class.[4]

Limited partnerships serve a variety of legitimate business purposes and are an important source of investment capital in the economy. However, there is growing concern that limited partnerships are being used to market abusive tax shelters to a larger number of taxpayers. In response to this concern, Congess enacted increased penalties for substantial underpayment of tax liability, new penalties for tax shelter promotions, and other compliance measures in the Tax Equity and Fiscal Responsibility Act of 1982.

Why Is Tax Shelter Marketing Increasing?

The continuing growth of tax shelters may appear surprising in view of the enactment of the Economic Recovery Tax Act of 1981, which reduced the top marginal rate from 70 percent to 50 percent, and the enactment of the Tax Equity and Fiscal Responsibility Act of 1982, which was a major effort to broaden the tax base and improve compliance. To understand why tax shelter activity has not abated, it is useful to analyze the market for tax shelters. On the demand side of the market are taxpayers with substantial taxable

[4] These data overestimate tax shelter partnerships to the extent that net partnership losses are due to adverse economic circumstances as opposed to tax deductions. The lowest income class is omitted from Table 2 in order to reduce this source of overestimation. However, *net* partnership loss data underestimate tax deductions to the extent that losses from one partnership offset profits from another.

income confronting high marginal tax rates. On the supply side of the market are users of tax-advantaged assets, such as real property, which during certain periods generate tax deductions in excess of income. The users of tax-shelter assets have an incentive to rent them from a tax shelter partnership, rather than own them, if they cannot take full advantage of the tax deductions because (1) they lack sufficient unrelated income to shelter, or (2) they have low marginal tax rates. Also on the supply side of the market are tax shelter promoters who organize and market limited partnerships interests in tax-shelter assets. The growth of tax shelter marketing is attributable to factors increasing both the supply and demand for tax shelters.

Supply factors

The supply of tax shelters is partly dependent on the ability of asset users to take advantage of the tax write-offs generated by their assets. The combination of the Accelerated Cost Recovery System (ACRS) and debt-financing, particularly in highly leveraged investments such as real estate, can generate tax deductions which are substantially larger than pre-tax income over the early years of the life of the property. It is interesting to note that debt-financing or ACRS alone will not, in general, cause the value of an investment's deductions to exceed the value of its pre-tax income in present value terms. However, in combination, tax deductions can greatly exceed pre-tax income. In these situations it is often difficult for asset users to fully utilize interest and depreciation deductions (and tax credits), which encourages asset users to lease from partnerships, the owners of which are better able to utilize tax write-offs (and credits).

In addition to ACRS, the tax write-off capacity of many asset users was also reduced by the sharp recession in 1981-82, which decreased income. Another factor which continues to reduce tax write-off capacity is high interest rates which squeeze the taxable income of debt-financed businesses. High interest rates also enhance tax shelter benefits which can be obtained by exploiting certain Code provisions that were originally drafted in periods of low interest rates and did not take proper account of the time value of money.

Another factor that may explain the proliferation of abusive tax shelters is the increasing complexity of the tax law, and the backlog of regulations, which appear to be providing more opportunity to take advantage of uncertainty in the tax laws.

Demand factors

The Economic Recovery Tax Act of 1981 (ERTA) reduced the top tax bracket on unearned income from 70 to 50 percent, a reduction of 29 percent, and by 1984 will have reduced other tax rates by 23 percent. This change alone should have decreased the demand for tax shelters since the value of a $100 write-off to a top bracket taxpayer dropped from $70 to $50. The ERTA also expanded eligibility for individual retirement accounts (IRAs) and increased the limitation on contributions to both IRAs and Keogh pension plans. Both of these changes would be expected to reduce taxpayer demand for marketed tax shelters. In addition, the rapid growth in tax-exempt bond issues would tend to reduce this demand.

On the other hand, an increase in demand for marketed tax shelters could be attributable to a lagged response to the rapid increase in marginal tax rates which occurred prior to the ERTA. Table 2 shows that from 1971 to 1981, the average tax bracket of individual taxpayers rose from 24.0 to 32.1 percent.

Table 2. Average Marginal Income Tax Rates, 1962–1982

Calendar year	Percent [1]
1962	24.9
1963	26.1
1964	22.7
1965	21.8
1966	22.2
1967	22.9
1968 [2]	27.0
1969 [2]	27.5
1970 [2]	24.5
1971	24.0
1972	24.4
1973	25.7
1974	26.2
1975	26.8
1976	27.8
1977	28.7
1979	29.6
1980	31.2
1981	32.1
1982 [3]	29.8

[1] Marginal tax rate (i.e., the rate applicable to the last dollar of income) for all returns, weighted by adjusted gross income.

[2] Includes Vietnam War surtax at 7.5 percent of individual income tax liabilities for calendar year 1968, 10 percent for Calendar Year 1969, and 2.5 percent for Calendar Year 1970.

[3] Data estimated for 1982.

It is likely that taxpayers do not immediately adjust their investment portfolios in response to an increase in their marginal tax rate. It takes time to compare and evaluate investment alternatives, and taxpayers may be cautious about investing in tax-oriented limited partnerships. Finally, the decline in the audit rate, from 2.2 percent of returns in fiscal year 1978 to 1.5 percent of returns in 1983, may have lowered the risk of buying shelters in the minds of some taxpayers.

In conclusion, the recent growth in tax shelter marketing appears to be explained by an overload of deductions and credits in the tax system as a result of the recession, ACRS, and high interest rates; and an increase in taxpayer interest in tax shelters as a lagged response to increasing marginal tax rates prior to 1982.

Approaches to reducing tax shelter marketing

The market for tax shelters can be reduced by policies which operate on the supply or the demand side of the market. There are several demand-side approaches: reducing marginal tax rates and (in the case of abusive tax shelters) increasing enforcement. Lowering the top tax bracket rates reduces the value of tax deductions offered by tax-shelter assets. This reduces the demand for all types of tax shelters. On the other hand, increasing tax enforcement reduces the demand for the more abusive types of tax shelters. Alternatively, a minimum tax can be used to reduce the extent to which any single taxpayer can utilize tax shelters. The present alternative minimum tax covers some, but not all, deductions and credits used in tax shelters and was significantly expanded in 1982. It would be possible to modify the alternative minimum tax further so that it more accurately reflects economic income. Another approach suggested by some is to prevent taxpayers from using investment losses to shelter unrelated income for alternative minimum tax purposes.

One approach to reducing the supply of tax shelters would be to broaden the tax base and, thereby, reduce the excess deductions and credits that encourage users of tax-advantaged assets to lease, rather than own, these assets. This strategy would require an examination of the tax incentives that Congress has enacted over the years. In view of the proliferation of real estate tax shelters, one incentive which might be reviewed is ACRS. For example, a proposed floor amendment to H.R. 4170 to be offered by Congressman Pease and others would increase the recovery period for structures to 20 years from the present 15 years. Other tax preferences could be reduced by extending the 15-percent cutback in corporate preference items enacted in 1982 (section 291) to individuals and, possibly, expanding its scope to cover other preferences or to have a more significant impact on certain of the preferences to which it applies.

A second approach would be to review the structural tax provisions that are being exploited by tax shelters to see if they can be modified in a way that eliminates abuses without harming ordinary business transactions. In this connection, the tax treatment of expenses involved in organizing tax shelters is especially important. Alternatively, special anti-tax shelter provisions could be grafted onto the existing rules (such as the at-risk provisions enacted in 1976).

Recently, there has been considerable interest in broad base income tax proposals with lower and flatter tax rate schedules. These proposals would reduce tax shelter activity on both the supply and demand sides of the market. On the supply side, base broadening reduces the amount of tax-shelter assets offering large deductions. On the demand side, tax rate reductions decrease the value of write-offs to taxpayers. Others favor replacing the income tax with a tax on consumed income, which might reduce the opportunities for tax shelters.

Economic Effects of Tax Shelters

The proliferation of tax shelters has had an important impact on revenues and on the efficiency and equity of the income tax system. The growth of shelters feeds on itself: as the tax base is eroded, rates must be raised to maintain revenues, which in turn increases the demand for tax shelters. This vicious circle threatens the integrity and fairness of the tax system as the tax burden falls increasingly on taxpayers who do not or cannot take advantage of tax shelters. The growth of tax shelters affects the fairness of the tax system in other important respects including shifts in the ownership of certain assets from low-bracket to high-bracket taxpayers. For example, farms are being sold to limited partnerships who can pay more than others due to their superior ability to utilize tax write-offs or their willingness to take more aggressive positions on their tax returns. This may bid up the price of farmland and may force sole proprietors out of agriculture.

Even the tax shelters based on incentives can have important affects on tax equity. For example, the Accelerated Cost Recovery System (ACRS) increased the value of depreciation deductions on rental housing purchased after 1981. This contributed to a construction boom which has glutted the real estate market in several southwestern cities. Post-1981 investors (often limited partnerships) can afford to lower rents or sustain high vacancy rates because of the generous ACRS deductions. However, the income of pre-1981 investors in real estate who rely on the old depreciation rules may have been reduced as rents fell in response to this oversupply. Thus the effect of some tax shelters can be to transfer wealth from existing investors to new investors. In other cases, taxpayers have bid up the price of existing buildings, providing windfalls to the existing owners.

The growth of tax shelters may have had an adverse impact on the efficiency as well as the fairness of the tax system. Tax shelter activity has significantly reduced the tax base over time, which has contributed both to higher deficits and the need for higher tax rates. In addition tax shelter marketing absorbs the talents of thousands of highly skilled professionals who might otherwise be employed in activities which contribute to the growth of GNP rather than the redistribution of the tax burden. Finally, in the case of shelters based on tax incentives, there is evidence that the government has lower cost alternatives than the creation of tax shelters, such as targeted spending programs, for encouraging certain types of economic activity. Tax shelters tend to be inefficient incentive mechanisms as a result of the high organizational and management fees charged by the tax shelter promoters. Tax shelter incentives are also inefficient to the extent that they attract investors taxed at less than the top tax bracket. If investors in the 40-percent bracket are interested in a tax shelter, then the benefit passed through to the users of the assets are determined by the tax benefits of these marginal investors. In this case, however, high-income investors in the 50-percent bracket are receiving a windfall, since the value of write-offs is 25 percent larger for these upper income investors. Thus, to the extent that these windfalls and organizational fees absorb the tax benefits of an incentive-type shelter, the tax system is an inefficient mechanism for increasing desirable economic activity.

IV. SUMMARY OF INCOME TAX PROVISIONS DESIGNED TO LIMIT TAX SHELTERS

Beginning in 1969, Congress has enacted substantive and procedural income tax provisions that deal with tax-shelter investments. These provisions have generally been enacted in lieu of more basic changes. Often, they have been narrowly drafted to deal with a specifically perceived abuse. Exceptions have often been created to achieve specific policies.

Following are brief summaries of the major changes contained in the Tax Reform Act of 1969, the Revenue Act of 1971, the Tax Reform Act of 1976, the Revenue Act of 1978, the Economic Recovery Tax Act of 1981 (ERTA), and the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).[1]

Minimum tax

In 1969, a minimum tax was enacted which applied to both individuals and corporations. The original minimum tax was an "add-on" tax which applied to a taxpayer whose defined tax preferences exceeded his regular tax by more than $30,000. In 1976, the tax rate was increased from 10 percent to 15 percent and the exemption greatly reduced. Since that time, the individual minimum tax has been amended several times.

TEFRA repealed the individual "add-on" minimum tax and replaced it with an "alternative" minimum tax beginning in 1983. This tax requires all individuals to pay a tax of at least 20 percent on their "economic" income (i.e., taxable income plus tax preferences) in excess of an exemption level of $40,000 for married couples and $30,000 for single taxpayers. The corporate "add-on" minimum tax was retained.

Investment interest limitation

Prior to 1969, a taxpayer was able to reduce tax on income from the taxpayer's professional or other income-producing activities by voluntarily incurring interest deductions attributable to tax-shelter investments. The 1969 Act limited the deduction for interest paid or incurred by an individual (and other noncorporate taxpayers) on funds borrowed to purchase or carry an investment. Under the 1969 Act, the deduction for investment interest was limited to 50 percent of the interest in excess of the taxpayer's net investment income, long-term capital gains, plus $25,000. The 1976 Act further limited the deduction for investment interest to $10,000 per year plus the taxpayer's net investment income. Disallowed interest deductions are carried over and may be deducted in future years.

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[1] See also pamphlet prepared by the staff of the Joint Committee on Taxation, "Background on Tax Shelters," JCS-29-83, June 23, 1983.

Investment tax credit: Noncorporate lessor limitation

The 1971 Act, which reinstated the investment credit, imposed limitations on the availability of the investment credit to individual (and other noncorporate) lessors. This provision was enacted to limit the extent to which individuals are able to utilize the tax benefits of leasing transactions (*i.e.*, the credit, depreciation deductions, and interest deductions) to shelter other income. Under present law, the investment credit is available to noncorporate lessors in only two situations: (1) if the leased property was manufactured or produced by the lessor, and (2) in the case of a short-term lease, where the lease term (including renewal options) is less than 50 percent of the useful life of the property, and for the first 12 months after the transfer of the property to the lessee, the sum of certain deductions allowable to the lessor with respect to the property exceeds 15 percent of the rental income produced by the property. The credit not usable by a noncorporate lessor may be passed through to a lessee (sec. 48(d)).

At-risk rules

Loss limitation.—As part of an effort to limit abusive tax shelters, the 1976 Act enacted an at-risk limitation to prevent a taxpayer from deducting losses in excess of the taxpayer's actual economic investment in an activity. The limitation applies to all activities except the holding of real property and certain corporate leasing transaction.[2]

Under the at-risk rules, a taxpayer may deduct losses (including depreciation) from an activity only to the extent of his or her aggregate at-risk investment in the activity at the close of the taxable year. In general, the at-risk investment includes (1) cash and the adjusted basis of property contributed by the taxpayer to the activity, and (2) amounts borrowed for use in the activity for which the taxpayer has personal liability for repayment. This amount is generally increased by the taxpayer's share of net income from the activity and decreased by its share of losses. At-risk investment does not include the proceeds of nonrecourse loans. The at-risk amount also excludes (1) amounts borrowed from other participants in the activity, (2) amounts borrowed from related parties, and (3) amounts with respect to which the taxpayer is protected against loss through guarantees, stop loss agreements, or other similar arrangements. However, the at-risk rules often will not apply where the taxpayer is personally liable on a note for the purchase of property, which is then leased to a credit-worthy lessee on a long-term lease.

The at-risk rules are applicable to individuals and certain closely held corporations.[3] An exception is provided for certain equipment leasing activities (not including the leasing of master sound recordings and other literary or artistic properties) engaged in by closely

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[2] As enacted in 1976, the at-risk rules applied to four specific activities: (1) farming; (2) oil and natural gas exploration; (3) holding, producing, or distributing motion picture films or video tapes; and (4) leasing of personal property. The Revenue Act of 1978 extended the at-risk rules to other activities.

[3] The Revenue Act of 1978 expanded the at-risk rules to cover closely held corporations. A corporation is subject to the at-risk rule if more than 50 percent in value of its outstanding stock is owned (directly or indirectly) by 5 or fewer individuals.

held corporations. In the case of partnerships or S corporations, the rules are applicable at the partner or shareholder level. Thus, a partner is considered at-risk with regard to a loan to the partnership only if the partner is personally liable for repayment.

H.R. 4170, as reported by the Committee on Ways and Means October 21, 1983, would exempt certain active businesses conducted by closely-held corporations from the at-risk rules and make certain other modifications consistent with the general policy of the rules.

Investment tax credit.—ERTA added a new at-risk limitation with respect to the investment tax credit (ITC). The limitation applies to the same activities, and to the same taxpayers, as the loss deduction at-risk rules.

Under the ITC at-risk rule, the basis of property for ITC purposes may not exceed the taxpayer's at-risk investment in the property at the close of the taxable year. In general, the amount at-risk for ITC purposes is determined on the same basis as under the loss deduction rules. However, an exception is provided for amounts borrowed from certain "qualified lenders" (including banks, savings institutions, and other commercial lenders) or from governmental authorities. A taxpayer is considered at-risk with regard to these amounts if he or she has at least a 20 percent at-risk investment in the property (determined without regard to the exception).[4] The law also provides an exception for property used in connection with various alternative energy sources.

H.R. 4170, as reported by the Committee on Ways and Means October 21, 1983, would replace the ITC at-risk rule with a new rule which excludes from the ITC credit base the amount of nonrecourse financing (except certain commercial financing) with respect to a property. This rule would generally be consistent with the policy of the existing ITC rule.

Farm operations

Farm operations are governed by special tax provisions, many of which confer tax benefits on farming activities. Under law, the special tax rules available to farmers were utilized by passive tax-shelter investors who were motivated, in large part, by a desire to use the special farming rules to shelter income from other sources. The 1976 Act contained several provisions designed to reduce the tax incentives for passive tax-shelter investors to invest in syndicated farming operations.

The 1976 Act limits the deductibility of prepaid feed, etc. by a farm syndicate, requires the capitalization of the pre-production expenses of a farm syndicate in growing fruits or nuts, and requires the use of the accrual method of accounting by farm corporations (other than certain small corporations and family corporations).

Recapture

The recapture rules under present law prevent the conversion of ordinary income to capital gains, by requiring gain on a sale or disposition of certain property to be taxed as ordinary income (rather

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[4]In the case of partnerships and S corporations, the 20-percent test is applied at the partner or shareholder level.

than capital gains) to the extent depreciation deductions were taken with respect to the property.

Real estate.—Among the tax benefits derived from a real estate tax shelter are accelerated depreciation deductions. The 1969 Act imposed more stringent recapture rules on real estate investments, requiring a larger portion of gain attributable to accelerated depreciation deductions to be taxed as ordinary income. However, under the 1969 Act, residential real property received favorable treatment. With limited exceptions, the 1976 Act provided for complete recapture of all depreciation in excess of straight-line depreciation, regardless of whether the property was residential real property. However, unlike personal property, only accelerated depreciation deductions are recaptured. For low-income housing, recapture is phased out based on the length of time the property is held.

Finally, under the Accelerated Cost Recovery System enacted by ERTA, all gain or disposition of nonresidential real property whose cost is recovered on an accelerated basis over the allowable 15-year period will be treated as ordinary income, to the extent of recovery allowances previously taken under the prescribed accelerated method. Thus, in the case of nonresidential property, taxpayers may either use straight-line recovery with no recapture, or accelerated recovery with recapture of all recovery deductions to the extent gain is recognized.

Intangible drilling and development costs.—Under present law, an investor in an oil and gas tax shelter can defer tax liability by deducting intangible drilling and development costs against ordinary income. The 1976 Act contained a recapture provision that prevents the conversion of the ordinary income against which such deductions are taken to capital gains. The amount subject to recapture is the amount deducted for intangible drilling and development costs, reduced by the amounts which would have been deductible had those costs been capitalized and deducted through cost depletion.

Production costs

The 1976 Act contained a provision that requires a taxpayer (other than a corporation that is not an S corporation or a personal holding company) to capitalize production costs of producing films, sound recordings, books, or similar property, and to deduct such costs over the life of the income stream generated by the production activity. This provision prevents a taxpayer from accelerating production costs, and, thereby, producing a mismatching of income and expenses attributable to the activity.

Sports franchises: Player contracts

Under prior law, the purchaser of a sports franchise attempted to allocate a large portion of the purchase price to player contracts that could be depreciated. The amount allocated to player contracts usually represented a large portion of the purchase price, and could be depreciated over a short life. The depreciation deductions taken in the early years usually exceeded the income generated by the franchise and, thus, sheltered other income. On the other hand, upon a subsequent sale of the sports franchise, the seller attempted to allocate most of the sales price to other assets (such as goodwill) that were not depreciable and, therefore, not subject to recapture. Thus, a sports franchise tax shelter could be used to obtain conversion, as well as deferral.

Under the 1976 Act, on the disposition of a sports franchise (or the creation of a new franchise), the amount of consideration allocated to a player contract must not exceed the sum of the adjusted basis of the contract in the hands of the transferor and any gain recognized by the transferor on the transfer. On a sale or exchange of a franchise, there is a presumption that not more than 50 percent of the sales price is allocable to player contracts. Further, the 1976 Act provided special recapture rules for depreciation deductions taken with respect to player contracts.

Partnerships

The Tax Reform Act of 1976 contained numerous provisions intended to limit the use of partnerships for tax-motivated transactions. The 1976 Act amended the tax laws; (1) in the case of the provision relating to additional first-year depreciation (as subsequently amended by ERTA, an election to expense certain depreciable business assets) to require a limitation on the amount of the deduction to be applied to the partnership and to each partner, (2) to require guaranteed payments to a partner to be capitalized if those payments to a party who is not a partner would have to be capitalized, and to require costs of organizing a partnership or promoting or selling interests when incurred by the partnership to be capitalized, subject to an election to amortize organization fees over a period of 60 months or longer; and (3) to limit allocations of partnership income or loss to a partner to the portion allocable to the part of the taxable year during which he is a partner, and to provide that such allocations will be controlled by the partnership agreement unless they do not have a substantial economic effect, in which case the allocation is to be made in accordance with the parners' interests in the partnership. (Prior to the Act, the allocation provisions referred only to items of partnership income, loss, deduction or credit and it was unclear whether they applied to allocations of overall income or loss. Also, the allocation in the partnership agreement was not controlling only if the principal purpose of the allocation was evasion or avoidance of tax. The "substantial economic effect" test had been adopted under Treasury regulations in applying the principal purpose test of prior law.)

Prepaid interest

Under the general rule of section 163(a), a taxpayer using the cash method of accounting can claim a deduction for interest paid within his taxable year. Prior to the 1976 Act, prepaid interest was used in many types of tax shelters to defer tax on ordinary income. In many cases, a deduction for prepaid interest was generated without adverse cash flow consequences by borrowing more than was needed and promptly repaying the excess as "prepaid interest." Under the 1976 Act, if a taxpayer uses the cash method of accounting, interest that is prepaid but that is properly allocable to a later taxable year must be deducted ratably over the period of the loan. This rule applies to all taxpayers (including individuals, corporations, estates, and trusts), and covers interest paid for personal, business, or investment purposes. Once prepaid interest has been allocated to the proper periods, such interest is then subject to other applicable limitations (*e.g.*, the limitations on the deduction of investment interest).

Construction-period interest and taxes

Under prior law, amounts paid for interest and taxes attributable to the construction of real property were allowable as current deductions, even if there was no income from the property. The ability to take current deductions for construction-period interest and taxes permitted the deferral of tax on other income. Under the 1976 Act, a taxpayer (other than a corporation that is not an S corporation or a personal holding company) is required to capitalize construction-period interest and taxes attributable to the construction of real property (other than low-income housing). The capitalized expenditures are amortized over a 10-year period. TEFRA extended the scope of the capitalization rule for construction-period interest and taxes to require all corporations to capitalize construction-period interest and taxes attributable to the construction of nonresidential real property.

Original issue discount obligations

Prior to TEFRA, holders of corporate bonds issued at a discount were required to include the total discount in income on a straight-line basis over the life of the bond and corporate issuers were permitted to deduct discount on the same basis. As amended by TEFRA, the original issue discount rules require the income inclusion and deduction at a constant interest rate, i.e., at a compound rate which parallels the manner in which interest would accrue on interest-paying nondiscount bonds. The original issue discount rules were also extended by TEFRA to cover noncorporate obligations other than those issued by individuals.

Stripped-coupon bonds.—Prior to TEFRA, some taxpayers took the position that a disposition of the corpus without the coupons with respect to coupon-bearing bonds resulted in income deferral by allocating the entire cost of the bond to the stripped corpus, producing an artificial loss. The stripped coupons in the hands of a purchaser became capital assets which, if disposed of prior to redemption, could result in capital gain. Under TEFRA, upon a disposition which separates ownership of the bond and the detached coupons, the stripped corpus and detached coupons are treated as obligations issued by a corporation on the date of disposition and are subject to the periodic income inclusion applicable to original issue discount bonds. The basis of the bond is allocated to the components, i.e., the corpus and each coupon, in accordance with their relative fair market values on the date of disposition.

Reorganizations.—Prior to the Technical Corrections Act of 1982, the original issue discount rules did not apply to obligations issued in a corporate reorganization. New obligations issued in exchange for a corporation's outstanding obligations in a recapitalization could provide for the deferral until maturity of payments exceeding both the issue price and the fair market value of the old obligations. Some issuers claimed deductions for interest accruals prior to payment without regard to the limitations applicable to the newly issued obligations under original issue discount rules. There was no taxable income to cash basis holders until maturity unless they disposed of the bonds earlier. This treatment would result in a substantial mismatching of the holder's income and the deduction under the claimed treatment by the issuer. The original issue discount rules were amended by the Technical Corrections Act to remove the exception for recapitalizations and other tax-free reorganizations.

Audit provisions

In 1982, new audit procedures were enacted for partnerships and S corporations. These provisions are effective for taxable years beginning after 1982. Under these provisions, the tax treatment of partnership and S corporation income, deductions, credits, etc. will be determined administratively and judicially in a single proceeding at the entity level. Partners and shareholders generally must be notified of the proceedings and may participate. The partners and shareholders are bound by the determinations and may not contest the determinations in separate proceedings.

Because these proceedings were not effective for years beginning before 1983, there is no experience as to the effect on tax shelters.

Penalties

Overvaluation penalty.—ERTA provided a graduated addition to tax applicable to certain income tax "valuation overstatements." The addition to tax applies to the extent of any underpayment of income tax attributable to such an overstatement, in the case of a taxpayer who is an individual, a closely held corporation, or a personal service corporation. However, the penalty does not apply with respect to property that has been held by the taxpayer for more than five years.

If there is a valuation overstatement, the following percentages are used to determine the addition to tax:

If the valuation claimed is the following percent of the correct valuation—	**The applicable percentage is—**
150 percent or more but not more than 200 percent	10
More than 200 percent but not more than 250 percent	20
More than 250 percent	30

The penalty may be waived if the valuation had a reasonable basis or was made in good faith. The penalty is effective for returns filed after December 31, 1981.

Addition to negligence and fraud penalties.—Prior to ERTA, an addition to tax, or penalty, with respect to certain tax underpayments due to negligence or civil fraud, was imposed. That penalty for negligence was 5 percent of any underpayment that is due to negligent or intentional disregard for rules and regulations. The penalty for fraud was 50 percent of any underpayment due to fraud.

ERTA imposed a further nondeductible addition to tax equal to 50 percent of the interest attributable to that portion of an underpayment which is attributable to negligent or intentional disregard for rules or regulations. TEFRA added a similar further addition to tax in the case of fraud.

Substantial understatement.—Under TEFRA, a penalty of 10 percent will be imposed on any substantial understatement of income tax. For this purpose, an understatement is the excess of the amount of income tax imposed on the taxpayer for the taxable year, over the amount of tax shown on the return. A substantial understatement of income tax exists if the understatement for the taxable year exceeds the greater of 10 percent of the tax required to be shown on the return for the taxable year, and $5,000 ($10,000 for corporations other than S corporations and personal holding companies).

The amount of the understatement will be reduced by the portion of the understatement that is attributable to (1) the treatment of any item for which there is or was substantial authority, or (2) any item for which there was adequate disclosure of the relevant facts on the return. In the case of a tax shelter, the reduction when there is substantial authority will apply only to the portion which the taxpayer believed was more likely than not to be the correct treatment. The disclosure defense is not avoidable in a tax shelter case. A tax shelter is defined as a transaction for which evasion or avoidance of income tax is the principal purpose.

The Secretary may waive all or a part of the penalty on a showing by the taxpayer that there was a reasonable basis for the understatement and the taxpayer acted in good faith. This penalty is in addition to all other penalties provided by law.

The penalty is effective with respect to returns which have a due date after 1982.

Penalty for promoting abusive tax shelters, etc.—Under TEFRA, a new civil penalty was imposed on persons who organize or sell any interest in a partnership or other entity, investment, plan or arrangement, when, in connection with such organization or sale, the person makes or furnishes either (1) a statement, which the person knows or has reason to know is false or fraudulent as to any material matter with respect to the availability of any tax benefit said to be available by reason of participating in the investment, or (2) a gross valuation overstatement as to a material matter which is more than 200 percent of the correct value.

The penalty for promoting an abusive tax shelter is an assessable penalty equal to the greater of $1,000 or 10 percent of the gross income derived, or to be derived, from the activity.

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. This penalty is in addition to all other penalties provided for by law.

This provision took effect September 4, 1982.

Action to enjoin promoters of abusive tax shelters.—TEFRA permits the United States to seek injunctive relief against any person engaging in conduct subject to the penalty for organizing or selling abusive tax shelters. Venue for these actions generally is the district in which the promoter resides, has his principal place of business, or has engaged in the conduct subject to the promoter penalty.

This provision took effect September 4, 1982.

The IRS has been successful in restraining the promotion of several illegal trust schemes and other illegal tax shelters under these provisions.

V. DESCRIPTION OF TAX-MOTIVATED TRANSACTIONS AND PROPOSED LIMITATIONS

Should the committee wish to reduce the benefits derived from and the growth of tax shelters, particularly abusive tax shelters, and other tax motivated transactions, it may wish to modify or expand various of the present law provisions designed to limit these activities. In addition, the committee may wish to consider the following proposals of the Administration and others dealing with specific types of transactions.

A. PARTNERSHIPS AND OTHER PASS-THROUGH ENTITIES

Present Law and Background

Tax-motivated transactions in general, and tax shelter investments in particular, often use structures in which the tax benefits can be passed through to passive investors. The form of entity most commonly used to accomplish this purpose in a tax shelter investment is a partnership.

A partnership is preferred because, under present law, it provides flexibility in the allocation of deductions to passive investors. A partnership does not incur income tax liability; rather individual partners are taxed currently on their share of partnership income and deduct currently their share of partnership losses to the extent of the basis of their partnership interests.

An investor's initial basis in his partnership interest includes the amount he invests and his share, if any, of partnership liabilities. Treasury regulations generally provide that partnership liabilities are allocated in accordance with the partnership ratio for sharing losses. The amount allocable to a limited partner, is limited to any contribution which he is required to make under the partnership agreement in excess of his existing investment. However, if no partner is personally liable for repayment, as in the case of nonrecourse liabilities, liabilities are allocated to all partners, including limited partners, in accordance with the ratio for sharing profits provided for in the partnership agreement. A recent case helds that nonrecourse partnership debt guaranteed by a general partner in a capacity other than as a partner is treated as nonrecourse debt providing basis to the limited partners to support the allocation of partnership losses to them. *Raphan v. United States* (U.S. Claims Court, No. 432–78; September 26, 1983). The Internal Revenue Service has ruled to the contrary. Rev. Rul. 83-151, 1983–41 I.R.B. 6.

The allocation of partnership overall income or loss, as well as items of partnership income, loss, deduction or credit is generally determined by the partnership agreement if the allocation under the agreement has a substantial economic effect. If the allocation does not have a substantial economic effect, allocations are made in accordance with the partners' interests determined by taking into account all facts and circumstances.

A limited partnership is generally preferred over a general partnership for tax shelter investments because the limited partners, generally passive investors, have limited liability for the debts of or claims against the partnership and because limited partnership interests can be readily marketed. Commencing with the Tax Reform Act of 1976, the limitation of the deduction of losses to amounts for which the taxpayer is personally at risk has diminished this advantage for most activities. However, real estate activities are excepted from the "at risk" limitations and real estate tax shelter investments in the form of limited partnership interests continue to provide deductions for losses attributable to nonrecourse liabilities.

Partnership classification

Whether a business entity is taxed as a partnership or as a corporation (and, thus whether losses can be passed through to the investors) depends upon which form of enterprise the entity more nearly resembles.[1] Treasury regulations list six major characteristics ordinarily found in a corporation. Two of these, associates, and an objective to carry on a business for joint profit, are shared by corporations and partnerships and are therefore irrelevant in determining the classification. With respect to the other four, i.e., continuity of life, centralization of management, limited liability, and free transferability of interests, an entity generally will be classified as a corporation rather than a partnership only if it possesses at least three of these four characteristics. Particularly as applied to limited partnerships, these characteristics (as developed in the regulations) have been criticized as unrealistic in that [2] a revision of the classification test that more realistically analyzes these factors and others would result in many entities now classified as partnerships being treated as corporations.

Without regard to the corporate resemblance test of the regulations, partnership treatment of interests that are widely marketed has been questioned.[3] The ability to make tax losses available to shelter unrelated income is greatly facilitated by the broad marketing of partnership interests.

Allocation of income and loss

Background.—An allocation of income or loss under a partnership agreement will be effective for tax purposes if the allocation has an economic effect that is substantial. The economic effect requirement has been interpreted to permit the partnership agreement to govern the allocation of deductions only if the partner to whom the allocation is made is liable to restore the amount deducted in the event that the amount deducted corresponds to an eco-

[1] Treasury regulations sec. 301.7701-2(a).

[2] Sexton and Osteen, *Classification as a Partnership or an Association Taxable as a Corporation*, 24 Tulane Tax Institute 95 (1975).

[3] *The Reform and Simplification of the Income Taxation of Corporations*, Senate Committee on Finance, September 22, 1983, p. 51; American Law Institute, Federal Income Tax Project, Subchapter K, Tentative Draft No. 7, pp. 95-97, 109 (1981). The Treasury Department opposed the proposal of the Senate Finance Committee report to deny partnership status to publicly traded partnerships. The Democratic Study Group's 1983 proposal would deny such status to partnerships with more than 100 members.

nomic loss sustained by the partnership.[4] For example, assume that A and B each contribute $50 to a partnership. The partnership acquires property at a cost of $100 and incurs depreciation expenses of $100 which are allocated to partner A. If the property is then sold for a $50 gain which is allocated equally to A and B, partner A will have a deficit in his capital account of $25 and partner B's capital account will be $75. The $100 loss allocated to partner A will be allowed only if he is required to restore the $25 deficit in his capital account when the partnership is liquidated. This interpretation of the economic effect requirement has been incorporated in proposed regulations.[5]

For the allocation provided in the partnership agreement to govern, the economic effect of the allocation must be substantial. Proposed regulations interpreting the substantiality test require a weighing of the likelihood and magnitude of a shift in economic consequences among partners against the shift in tax consequences resulting from the allocation. A strong likelihood that an allocation which significantly reduces tax liability will be transitory due to offsetting allocations will cause the economic effect of the allocation to be treated as not substantial. Other factors, including the treatment of related items, recognition of normal business factors, whether the allocation is made before or after the amount is known, and the duration of the allocation, are also taken into account in determining substantiality.

When losses are attributable to nonrecourse liability, their allocation to any partner is without substantial economic effect since, by definition, no partner is liable to restore the amount deducted in the event that it reflects a true diminution in value which is realized upon disposition of partnership property. Only the creditor providing the nonrecourse loan sustains the economic loss in such case. However, the basis of partnership property includes both recourse and nonrecourse indebtedness to acquire the property. Basis reductions attributable to cost recovery deductions may result in taxable gain when the property is disposed of, whether by sale, foreclosure, or other disposition, because the indebtedness, to the extent not previously amortized, is treated as an amount realized when discharged upon such disposition. Reductions in the loan through loan amortization payments are treated as payments of cash to the partners and may also produce taxable gain if they exceed the basis of the partner for his interest in the partnership.

The proposed regulations would allow an allocation of deductions attributable to nonrecourse liability provided the partners to whom such allocation is made are charged with any taxable gain from amortization of the indebtedness or its discharge upon disposition of the property. Since any special allocation of nonrecourse liability is without economic effect, this "gain-chargeback" rule, in order to comply with the requirements of the statute, must satisfy the requirement that the allocation accords with the partners' interests in the partnership. However, the proposed rule excludes from consideration other facts and circumstances, particularly facts bearing

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[4] This interpretation of what constitutes an economic effect is based largely on the analysis in *Stanley C. Orrisch*, 55 T.C. 395 (1970), *aff'd per curiam*, 31 AFTR 2d 73-1069 (9th Cir. 1974).

[5] 48 *Fed. Reg.* 9671 *et seq.* (March 9, 1983).

on the economic sharing of profits and losses aside from tax consequences, which would be required to be considered in determining whether allocations not attributable to nonrecourse liability satisfy the statutory standard. It is understood that the Treasury Department will reconsider the treatment of nonrecourse liability.[6]

Assignment of income and loss.—In addition to allocations of overall ("bottom line") partnership income or loss, the partnership agreement may provide for allocations of particular items of income and deduction. For example, $100 of net income exclusive of cost recovery deductions and $100 of cost recovery deductions, from allocating the income to partner A and the cost recovery deductions to partner B provided the economic effect of such allocations is substantial in relation to their tax effect (although the partnership overall has no taxable income or loss). The allocation of all or nearly all cost recovery deductions to limited partners (generally passive investors) may be particularly attractive in a real estate tax shelter investment.

Opportunities to allocate partnership items so as to assign income or losses among partners are intended to be restricted by the substantial economic effect requirement as it may be amplified in Treasury regulations. However, special allocations of items of partnership income or loss could be restricted explicitly to prevent the allowance of losses where the partnership has no net loss.

1. Use of Allocations to Affect Income or Loss

Present Law and Background

Allocations with respect to contributed property.—Under present law, income, gain or loss, and depreciation or depletion can be effectively assigned in some cases to a partner regardless of economic effect. This result derives from the contribution of property by a partner to a partnership with a value above or below its basis to the partner. The partnership acquires the partner's basis in the contributed property and thus also acquires the built-in gain or loss economically accrued prior to the contribution.

Unless the partnership elects (as permitted by present law) to treat the gain or loss and any depreciation or depletion attributable to the contributed property in a manner that accounts for the difference between its basis and its value at the time of contribution, gain or loss is allocated as if the property had been purchased by the partnership. Thus, gain or loss economically accrued to the

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[6] The application of the proposed regulations to nonrecourse liabilities has been criticized as offering a vehicle for the transfer of tax benefits similar to safe harbor leasing. Comments of the Commtitee on Partnerships of the New York State Bar Association Tax Section (May 12, 1983) at pp. 32-38. It has also been suggested that a gain-chargeback provision will not satisfy the statutory requirements as applied to nonrecourse liability and that the allocation of tax benefits must be compared to economic benefits calculated without regard to tax benefits in order to determine the validity of the allocation. Krane and Sheffield, "*Beyond Orrisch: An Alternative View of Substantial Economic Effect Under Section 704(b)(2) Where Nonrecourse Debt is Involved*", 60 *Taxes* 937 (1982); American Law Institute Federal Income Tax Project, Subchapter K, Tentative Draft No. 3, p. 115 *et seq.* (1979). On the other hand, it has been contended that the proposed regulations insofar as they relate to the treatment of losses attributable to nonrecourse debt, are a valid and appropriate interpretation of present law. However, the proponents of this view also suggest that certain additional restrictions could be added to provide a safe-harbor rule for nonrecourse deductions. Memorandum from ad hoc committee of tax lawyers to the Assistant Secretary for Tax Policy on proposed regulations relating to nonrecourse liability dated, May 24, 1983.

contributing partner can be assigned to other partners for the duration of the partnership. For example, if partner A contributes property with a basis of $10 and a value of $100 while partner B contributes $100 in cash to partnership, the initial capital accounts of both partners are set at $100. A subsequent sale of the property for $100 may result in an allocation of $45 of gain to each partner, thereby shifting $45 of gain from A to B. If the partnership were ultimately liquidated, A would have a gain of $45 and B would have a loss of $45. If the property contributed by A had a basis of $200 and a value of $100, the sale would result in the shifting of $50 of A's loss to B. If the partnership were ultimately liquidated, A would have a loss of $50 and B would have a gain of $50. A comparable situation occurs when a partnership interest is acquired by a cash contribution and the new partner shares in appreciation or depreciation in partnership assets that economically accrued prior to his entry.

As explained hereafter, the character of income, gain or loss attributable to property in the hands of a partner may also be affected by contributing the property to a partnership.

The elective treatment of contributed property under present law and the allocation of built-in gains and losses to old partners upon entry of a new partner are inconsistent with a strict prohibition of allocations of items of partnership income or deduction. Thus, any limitation on item allocations would have to resolve of the problems posed by these transactions.

Retroactive allocations of partnership losses.—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, so-called "retroactive allocations" of partnership losses. Some taxpayers take the position that, in applying this restriction, partnership income and losses are not considered to pass through to partners until the close of the partnership's taxable year. Thus, if an investor, rather than acquiring an interest in the operating partnership which sustained the loss, acquires an interest in a second partnership which in turn is a partner in the operating partnership, there is no retroactive allocation because the operating partnership's loss does not pass through to the second partnership until the close of the second partnership's taxable year, i.e., until after the investor has acquired his interest. The Internal Revenue Service has taken the position that losses are sustained by the second partnership in this case at the same time they are sustained by the operating partnership and that the limitation against retroactive allocations is equally applicable whether an investor acquires his interest in an operating partnership directly or through a second partnership. Rev. Rul. 77-311, 1977-2 C.B. 218.

In addition to tiered arrangements, cash basis partnerships, by deferring payment of deductible items until near the close of the partnership's taxable year, can be used to allocate to a partner losses that have economically accrued prior to his entry into the partnership.

Administration Proposals

Contributed property.—Under the Administration proposal, the rules relating to the allocation of gain or loss, depreciation, and depletion with respect to contributed property (sec. 704(c)) would be changed. Under the new rule, depreciation, depletion, and gain or loss with respect to contributed property would be shared among the partners, pursuant to Treasury regulations, so as to take account of the variation between the partnership's basis for the property and the fair market value of the property at the time of contribution. Thus, a partnership would generally be required, rather than being permitted to elect (as under present law), to allocate pre-contribution appreciation or depreciation of property (i.e. "built-in" gain or loss) to the contributing partner. This would prevent the use of partnerships to transfer gain or loss on contributed property without regard to economic effect.

Retroactive allocations.—The Administration proposal would prohibit taxpayers from using cash-basis partnerships or tiered partnership arrangements to make retroactive allocations to newly admitted partners. Under the proposal, if a partner's interest in a partnership changes during the taxable year of the partnership, each partner's distributive share of partnership income, gain or loss, deduction, or credit, or any item thereof, would be determined by use of any method prescribed by Treasury regulations which takes into account the varying interests of the partners during the taxable year. In the case of certain items (including interest, taxes, and payments for the use of property) with respect to which the partnership uses the cash method of accounting, each partner's distributive share would be determined by allocating the item over the period to which the item was attributable. Each partner could thus deduct only that portion of these items which actually accrued during the period for which he was a partner.

In the case of tiered partnership arrangements, the proposal would require items attributable to a subsidiary partnership or partnerships (except to the extent which may be provided by regulations) to be allocated to the parent partnership on a daily basis for each day in the taxable year during which the parent has an interest in the subsidiary partnership(s). This change would not affect the taxable year of the parent partnership.

Other Possible Proposals

Allocation of partnership liabilities.—The Committee may wish to consider clarifying present law by reversing the holding in *Raphan v. United States,* supra, and providing that indebtedness for which a general partner is presently or contingently liable (whether in his capacity as a partner or otherwise) is not nonrecourse liability providing basis for the limited partners' interests. When a limited partner is obligated to make a future contribution pursuant to the partnership agreement, it may be appropriate to limit any increase in his basis attributable to such obligation to amounts which he is required to be contributed within 2 years after the taxable year with respect to which the basis determination is made.

Publicly traded partnerships.—The Committee may wish to consider a proposal by Mr. Pease to limit the use of partnerships to create publicly tradeable tax losses by treating partnerships with more than 100 members as corporations. Alternatively, the Committee could consider a Senate Finance Committee Study proposal that publicly traded partnerships be treated as associations taxable as corporations. This treatment could be applied only to partnership's interests in which are traded on an established securities exchange. The Treasury Department opposed this proposal in testifying before the Senate Finance Committee.

2. Use of Partnerships to Convert Character of Income or Deductions or to Defer Income

Present Law and Background

Character of gain or loss.—The character of income or loss from the disposition of property by a partnership generally is determined at the partnership level. As a result, a contribution of property to be sold to a partnership by a partner, followed by a sale of the property, may result in a character of gain or loss different from that which would have resulted from a direct sale by the partner. Thus, ordinary income may be converted into capital gain when dealer status exists at the partner, but not the partnership, level. Conversely, a capital loss may be converted into an ordinary loss when dealer status exists at the partnership but not the partner level. For example, a taxpayer owning securities which have declined in value may attempt to convert his capital losses into ordinary losses by contributing the securities to a 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.

Organizational fees and other capital expenditures.—Amounts expended to organize a partnership or promote the sale of partnership interests, subject to an election to amortize certain organizational expenses, must be capitalized rather than currently deducted. Denial of the current deduction of such costs was made explicit by the partnership provisions of the Tax Reform Act of 1976. However, if the organizer or syndicator is also a general partner, allocation of partnership gross income to such person may have the effect of a deduction to the other partners for organizational and syndication fees paid to such person. The capitalization requirement for other types of expense can be avoided as well by this technique. Present law provides generally that, if amounts are paid or payable to a partner when he engages in a transaction with the partnership in a capacity other than as a member of the partnership, or if guaranteed payments are made to a partner for services, such payments are required to be capitalized to the same extent as comparable payments to a party who is not a partner.

Disguised sales.—In addition to services, a transfer of property from a partner to a partnership coupled with a related transfer of cash or other property from the partnership to the partner can be structured as a contribution to, and distribution from, the partnership, resulting in no gain being recognized to the partner. Case law has permitted this result under present law in transactions that are economically indistinguishable from sales by a contributing partner to the other partners.

Uses of tiered partnerships.—Tiered partnerships are also used to achieve results which may be unintended. For example, if a partnership interest is sold, a portion of the gain on the sale of the partnership interest is treated as ordinary income to the extent attributable to certain ordinary income assets of the partnership (sec. 751). However, if the ordinary income assets are held in a second partnership which is owned in part by the partnership whose interest is sold, it is not clear whether any of the gain is treated as ordinary income.

Another device (commonly referred to as a "California Basis Strip") involves taking advantage of inconsistent elections to step up (or down) the basis of partnership assets when a partnership interest is distributed or transferred (sec. 754). For example, assume that partnership AB holds 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 has a zero basis for his interest, will result in A holding the asset at a zero basis, and the basis of asset 1 will be increased to $100, assuming that the partnership has a section 754 election in effect (secs. 732 and 734). Thus, if asset 1 is sold, no gain or loss will be realized but if asset 2 is sold, A will realize $100 gain. However, if asset 2 is instead contributed to a second partnership in which partnership AB has a major interest, its basis will remain $100 (sec. 723). A distribution of AB's interest in the second partnership to partner A will result in the basis of the interest being reduced to zero but the basis of asset 2 will remain $100 (if the second partnership has not made a section 754 election). Thus, the effect is an increase in total basis of assets so that, in this example, both asset 1 and asset 2 can be sold without the recognition of gain, notwithstanding the reduction of basis in A's interest in the second partnership.[7]

Administration Proposals

Character of gain or loss.—Under the Administration proposal, if a partnership disposed of property within 5 years after its contribution by a partner, and if the property was inventory property in the hands of the partner immediately before such contribution, any gain recognized by the partnership on the disposition would be treated as ordinary income. Thus, built-in gains on such items (together with later appreciation) would retain their ordinary income character for five years after the date of contribution. Built-in losses on capital assets would retain their character as capital losses for 5 years after the date of contribution but only to the extent that the adjusted basis of the property to the partner exceeded its fair market value immediately before contribution (i.e. to the extent of pre-contribution losses). Gain on the sale of unrealized receivables contributed to a partnership would be treated as

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[7] See Freeman, "*Same Fun and Games with Multi-tiered Partnerships: A Developing Conceptual Awareness and a Medley of Planning Techniques* 61 *Taxes*, 895, 914 (1983).

ordinary income regardless of the date of disposition. Special rules would also apply in the case of any property the basis of which is determined by reference to the basis of ordinary income property.

To prevent the use of tiered partnerships to avoid ordinary income consequences on the sale of a partnership interest, a partnership would be treated as owning its share of any property owned by a second partnership in which it is a partner. A similar rule would apply under regulations in the case of interests in trusts.

Organizational fees and other capital expenditures.—The Administration proposal would provide a special rule for cases in which a partner performs services for, or transfers property to, a partnership, the direct payment for which property or services would be required to be capitalized by the partnership, and receives a related allocation (directly or indirectly) of partnership income or gain. Under this rule, the transaction would be treated as if it had been a transaction between the partnership and a person who is not a partner. Thus, the allocation to the partner would be ignored, and the partnership would be required to capitalize the amounts transferred to the partner for the property or services.

Disguised sales.—The proposal would also provide that, when a partner transfers property to a partnership and there is a related transfer (directly or indirectly) of money or other property to that partner, the transaction would be treated as occurring between the partnership and a person who is not a partner. This would prevent the parties from characterizing an effective sale of property as a contribution of the property followed by a distribution from the partnership to the contributing partner (thereby deferring tax on the transaction). Under the proposed rule, the related contribution and distribution would be treated as a taxable sale of all or part of the property.

Other Possible Proposal

Tiered partnership arrangements.—In addition to the Treasury proposals regarding tiered partnerships described elsewhere Congress may wish to prohibit the use of inconsistent elections to step up the basis of partnership assets when a partnership interest is distributed or transferred (the "California Basis Strip"). One method of preventing this result would be to require that, when a partnership has elected to make an optional basis adjustment upon a distribution (sec. 754), and the partnership distributes to its partners interests in a second partnership, the second partnership would be treated as if it had a similar election in effect.

3. Other Partnership Proposals

Present Law and Background

Like-kind exchange treatment of partnership interests.—Property held for productive use in a trade or business or for investment may be exchanged tax-free for property of like kind. This treatment does not apply if the property exchanged consists of inventory, stocks, securities, choses in action or other evidences of indebtedness or interest. It is unclear, under present law, whether an interest in one partnership may be exchanged for an interest in another partnership as a tax-free exchange of like-kind property. The Internal Revenue Service has ruled that the exception for interests in financial enterprises applies to partnership interests and thus they do not qualify as like-kind property that may be exchanged tax-free. Rev. Rul. 78-135, 1978-1 C.B. 256. Court decisions have held that exchanges of partnership interests may qualify for tax-free treatment as like-kind property where the underlying assets of the partnerships are substantially similar in nature. *Estate of Rollin E. Meyer, Sr.*, 58 T.C. 311 (1972); *Gulfstream Land and Development Co.*, 71 T.C. 587 (1979). However, it has also been held that an exchange of a general partnership interest for a limited partnership interest does not satisfy the like-kind requirement. *Estate of Meyer, supra, aff'd per curiam*, 503 F. 2d 566 (9th Cir., 1974).

Special considerations may apply in determining whether like-kind exchange treatment should be available to facilitate the exchange of partnership interests in tax shelter investments for interests in other partnerships. Under certain circumstances, taxation of the gain inherent in an interest in a "burned out" tax shelter, i.e., one with substantial outstanding liability which has been reflected in prior tax losses without a reduction in the indebtedness, may be avoided if the interest may be exchanged tax-free for an interest in another partnership.

At-risk rules.—The at-risk rules were enacted in 1976, and extended in 1978, to prevent taxpayers from deducting losses (including depreciation) in excess of the taxpayer's actual economic risk in activity (see Part IV above). ERTA added a similar at-risk limitation on the investment tax credit. Real estate investments are specifically exempted from the at-risk rules.

The at-risk rules prevent a taxpayer from deducting losses or receiving an investment tax credit to the extent that the taxpayer's investment in an activity or property is financed by indebtedness for which the taxpayer is not personally liable (including nonrecourse indebtedness). Because limited partners are not personally liable for partnership debts beyond the extent of their capital contributions, the at-risk rules significantly limit the tax benefits associated with non-real estate limited partnerships.

Interest on indebtedness used to acquire limited partnership interest.—The deduction of investment interest is limited to net investment income plus $10,000 under present law. It is not clear whether interest incurred on indebtedness assumed to acquire a limited partnership interest is subject to this limitation. A limited partnership interest represents an investment analogous to an investment in another business entity in which the taxpayer does not participate such as a stock interest.

Administration Proposal

Like-kind exchanges.—Under the proposal, tax-free like-kind exchange treatment would be unavailable for exchanges of partnership interests in different partnerships.

Other Possible Proposals

Extension of at-risk rules to real estate limited partnerships.—As an alternative to prohibiting special allocations of partnership income, deductions, and credits, the Committee may wish to reduce the tax advantages associated with real estate limited partnerships by subjecting such partnerships to the existing at-risk rules Alternatively, the Committee could extend the at-risk rules only to publicly traded real estate limited partnerships.

If real estate limited partnerships were subjected to the at-risk rules, investors in such partnerships would be denied deductions for interest and depreciation on a property, and an investment tax credit, to the extent that the partnership's acquisition of property was financed with nonrecourse indebtedness. This would have the effect of substantially reducing the tax benefits associated with such partnerships. The Committee may also wish to provide special rules applicable to sale-leaseback real estate transactions involving a long-term lease.

Interest on indebtedness to acquire limited partnership interest.— The Committee may wish to provide expressly that the limitation on deducting investment interest applies to indebtedness related to the acquisition or carrying of a limited partnership interest.

4. Transactions in Mutual Fund Shares

Present Law and Background

Distributions by a mutual fund from long-term capital gain income may be treated as long-term capital gain to its shareholders (i.e., the character of the capital gain is flowed through to the shareholders), regardless of whether a shareholder has held the mutual fund for over one year. After the distribution of a capital-gain dividend, the market value of a mutual fund's shares usually decreases by approximately the amount of the capital-gain dividend. Thus, absent an applicable statutory provision, a taxpayer could convert short-term gain to long-term gain by purchasing mutual fund shares just before a capital-gain dividend becomes payable, and then, immediately after the receipt of the dividend, selling the shares (realizing a short-term capital loss which is deductible against short-term capital gain).

Under a special rule, if mutual fund shares are sold at a loss after a capital-gain dividend date, and the shares were held for less than 31 days, then the loss is treated as a long-term capital loss to the extent of the capital-gain dividend on the shares. However, a taxpayer can avoid the application of this rule simply by holding mutual fund shares for 31 days or more. Thus, taxpayers retain the ability to engage in transactions in mutual fund shares as a device to achieve conversion. Similar rules apply with respect to real estate investment trusts (REITs).

Administration Proposal

All losses recognized on the sale or exchange by a shareholder of a RIC or REIT would be long-term to the extent capital-gain dividends were paid on the shareholder's stock, unless such stock is held for more than six months. It may be appropriate to provide an exception for certain periodic redemption plans.

5. Taxation of Multiple Trusts

Present Law and Background

Trusts are treated as taxable entities with respect to certain undistributed income. In a progressive tax system, it has been possible significantly to reduce taxable income by establishing multiple trusts having the same grantor and the same or similar beneficiaries.

Treasury regulations enacted following the Tax Reform Act of 1969 provide that multiple trusts will be treated as one trust if they have (1) the same grantor and substantially the same beneficiary, (2) no substantially independent purposes (such as independent dispositive purposes), and (3) a principal purpose of avoidance or mitigation of progressive rates of tax (including mitigation as a result of tax deferral) or avoidance or mitigation of the alternative minimum tax.[8]

In *Edward L. Stephenson Trust v. Commissioner*, 81 T.C. No. 22 (September 12, 1983), the Tax Court held that the Treasury 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.[9]

Possible Proposal

The Committee may wish to consider overruling the decision in *Edward L. Stephenson Trust v. Commissioner* and reinstating the tax avoidance test for treatment of multiple trusts as contained in the Treasury regulations.

6. Tiered or Federated Cooperatives

Present Law

A cooperative is an organization, usually operating in corporate form, which is established and operated for the mutual benefit of its members and patrons by selling goods to them or purchasing products from them and returning to them any income in excess of costs (sec. 1381). Unlike other corporations, a cooperative is allowed a deduction from its taxable income to the extent patronage source income is distributed to its members or patrons as a patronage dividend[10] or in redemption of a nonqualified written notice of alloca-

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[8] Treas. Reg. sec. 1.641(a)-0(c).

[9] *Estelle Morris Trusts v. Commissioner*, 51 T.C. 1968, *aff'd per curiam* 427 F.2d 1361 (9th Cir. 1970).

[10] In general, an amount is a patronage dividend if it is payable out of patronage source income to all patrons of the cooperative equally on the basis of business done with or for patrons.

tion (sec. 1382). Certain farm cooperatives also are allowed deductions for dividends paid out of nonpatronage source income. Additionally, a cooperative may exclude income attributable to qualified per-unit retain allocations and redemptions of nonqualified per-unit retain certificates.[11]

Only amounts paid within 8-1/2 months of the close of the cooperative's taxable year are entitled to this special treatment. Additionally, a dividend may be a patronage dividend only if it is paid to a member or patron of the cooperative who was such during the taxable year when the income giving rise to the dividend was earned.

Patronage dividends are includible in the income of a member or patron when paid or accrued (sec. 1385).

Issue

Cooperatives often operate on a "federated" basis, i.e., local cooperatives are patrons of other cooperatives operating on a regional or national basis. These cooperatives (and their individual patrons) may have different taxable years. This fact combined with the rule permitting patronage dividends to be deducted if paid within 8-1/2 months after close of a cooperative's taxable year can result in patronage earnings being distributed to a lower -tier cooperative and subsequently to an individual patron (generally the only party who is taxed on the income) in a taxable year subsequent to the year in which the income is earned.

Additionally, because patrons of cooperatives change from year to year, the lower-tier cooperatives or individuals receiving patronage dividends may not have been patrons of the cooperative when the income generating the dividend was earned.

Possible Proposal

One solution to the problem would be to limit patronage dividend deductions by cooperatives to dividends which would be recognized as income by individual patrons within 2 years after the close of the taxable year in which the income generating the dividend is earned.

7. Tax-free Step-up in Basis for Distributions by Trusts and Estates

Present Law and Background

Trusts and estates are separate income taxable entities; however, a deduction for distributions of income to beneficiaries is provided in determining the taxable income of such entities (secs. 641, 651, and 661).[12] In the case of a trust or estate making distributions of amounts in excess of its income, the deduction is limited to the amount of the trust's distributable net income (DNI).

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[11] A per-unit retain allocation is, in general, an amount retained by the cooperative with respect to goods marketed by the cooperative for the patron.

[12] Notwithstanding the general rule, a trust is taxable on the sale of appreciated property within two years of its receipt (sec. 644). This tax is in addition to any other tax imposed on the trust or a trust beneficiary.

Amounts distributed by a trust or estate generally are included in the beneficiary's gross income to the extent of the trust's or estate's distributable net income (secs. 652 and 662).

Distributions by a trust or estate may take the form of cash or other property. When property other than cash is distributed, the beneficiaries must take into gross income, and the trust or estate is allowed a deduction, for the fair market value of the property on the date of the distribution to the extent of the trust's or estate's distributable net income. In addition, the basis of the property in the hands of the beneficiary is "stepped up" to the extent it was included in his gross income. However, in such a case, the basis in the property is "stepped up" tax-free (i.e., the gain is taxed to neither the trust (or estate) nor to the beneficiary).

Possible Proposal

A possible solution would be to tax the trust or estate on the built-in gain or loss on the property to the extent of the trust's or estate's distributable net income. An alternative would be to limit the distribution deduction to the trust or estate and the amount includible in the gross income of the beneficiary to the amount of the trust's or estate's basis in the property. The basis of the property in the hands of the beneficiary would be the same as in the hands of the trust or estate.

B. TAXATION OF CORPORATIONS AND THEIR SHAREHOLDERS

The United States taxes corporations and their shareholders under the so-called "classical" system of corporate taxation, a system under which the corporation and its shareholders are separately taxed. In general, corporate earnings are taxed to the corporation and not to its shareholders, and a shareholder is taxed at ordinary income rates only on dividends received, and at capital gains rates when the corporation is liquidated or the shareholder disposes of his stock.

The Code contains a number of provisions to mitigate double taxation of earnings that remain in corporate solution, as well as numerous provisions intended to insure that both the corporation and its shareholders are taxed at appropriate rates. The interaction of these relief and anti-abuse provisions can have unintended tax results.

In general, a corporate shareholder can deduct 85 percent of dividends received from other corporations (sec. 243). Because the maximum rate of tax on corporate income is 46 percent, the maximum effective rate of tax on dividends received by a corporation is only 6.9 percent (46 percent of 15 percent). An alternative tax rate of 28 percent applies to a corporate taxpayer's long-term capital gain, if the tax computed using that rate is lower than the corporation's regular tax. A corporation can deduct capital losses only against capital gains.

1. Dividends Received by Corporations

Because dividends received by a corporation are subject to preferential tax treatment, some corporations have engaged in transactions to convert other income to dividend income. Similarly, the limitation on the deductibility of capital losses provides an incentive to engage in transactions that enable corporate taxpayers to utilize capital losses that would be unusable otherwise.

a. Debt-financed portfolio stock

Present Law and Background

When a corporation borrows the funds used to purchase dividend-paying stock, interest on the acquisition indebtedness is generally deductible against ordinary income. Thus, a corporation that borrows to finance purchases of portfolio stock effectively converts ordinary income to tax-favored dividend income. Another concern raised by the tax treatment of leveraged stock purchases is that, instead of the two taxes on corporate income (once at the corporate level and again at the individual-shareholder level) generally required by present law, the conjunction of a dividends received deduction and an interest deduction may result in avoidance of the corporate-level tax on corporate earnings.

Administration Proposal

Under the Administration proposal, interest deductions would be disallowed where, but for the stock investment, the related indebtedness would not have been incurred. The amount disallowed would be equal to the dividends received deduction claimed for dividends on the stock investment. The proposal would not apply with respect to dividends received from an 80-percent owned subsidiary. The proposal would generally apply to leveraged stock purchases after the date of enactment. Another approach that would address the concerns raised by leveraged stock purchases is to limit the deduction for dividends received on debt-financed stock.

The committee may wish to consider a more effective limitation, under which interest would be disallowed on indebtedness related to the stock investment although not directly allocable to the stock under the "but for" standard of the Administration's proposal.

b. Extraordinary dividend received by corporations

Present Law and Background

Dividends received deduction

Dividends received by a corporation generally have no effect on the recipient's basis in the stock of the distributing corporation. A corporate taxpayer that has a capital gain can purchase stock shortly before a dividend payment date, deduct 85 percent of the dividends received against ordinary income, and then sell the stock after satisfying a 16-day holding period (91 days for certain preferred stock). The sale of the stock at a decreased market value (resulting from the dividend payment) will generate a short-term capital loss (approximating the amount of dividends received). The short-term capital loss offsets the corporation's unrelated capital gain. Thus, a corporation can effectively convert capital gain (taxable at a maximum rate of 46 percent for short-term gains, or at the alternative rate of 28 percent in the case of long-term gain) to tax-favored dividend income. Technically, this corporate tax-motivated transaction cannot be done with respect to stock lent by a corporation for use in a short sale, since payments in lieu of dividends are not eligible for the dividends-received deduction. However, there appears to be widespread noncompliance in this area, so that the dividends-received deduction frequently gets claimed more than once with respect to the same dividend.

Example.—Chrysler's cumulative preferred stock sells at $36 per share shortly before Chrysler is scheduled to distribute $11.69 per share of back dividends. Corporation X has a short term capital gain of $1 million, on which it will owe tax of $460,000. It buys 85,000 shares of Chrysler preferred for $3,060,000 and holds it for 91 days. When the stock goes ex-dividend, the price drops to $24.31 per share. Assume corporation X eventually sells the stock for $24.31. Corporation X has a capital loss of $11.69 per share, or $993,650, which reduces the tax on its capital gain to $2,921, or by $457,079. It receives a dividend of $993,650, of which 85 percent, or $844,603 is excluded. The tax on the rest of the dividend is $68,562. Thus, the transaction saves $457,079 of capital gain tax at a price of $68,562 of dividend tax, a net gain of $388,517. This gain is likely to exceed, by far, whatever economic consequences result from fluctuations in the market value of Chrysler preferred during the 91-day mandatory holding period.

Holding period of distributed property

The recipient corporation's holding period in the distributed property equals that of the distributing corporation. Thus, when the distribution consists of appreciated property held by the distributing corporation for more than one year (e.g., interests in oil and gas wells being distributed through a royalty trust arrangement), the recipient corporation can sell the distributed property immediately and receive a long-term capital gain. Alternatively, the corporation could donate the distributed property to a charity and deduct the property's full value against ordinary income as a charitable deduction.

Example.—Louisiana Land and Exploration Company distributes a royalty trust to its shareholders worth $6 per share. The oil and gas wells that make up the assets of the trust have a zero basis because their costs were written off years ago as intangible drilling or depletion deductions. Corporation X buys Louisiana Land for $30 just before the ex-dividend date. Corporation X pays no tax on the $6 dividend because corporations are subject to tax only on the basis (in this case, zero) of distributions of appreciated property. The next day, corporation X sells the royalty trust for $6. The $6 of income is a long-term capital gain. Fifteen days later, corporation X sells the Louisiana Land stock for $24. Its $6 loss on the stock is a short-term capital loss. Thus, in a transaction with minimal economic substance, corporation X has generated a short-term capital loss and a long-term capital gain. If it started with a short-term capital gain, that gain will be converted into a long-term capital gain.

Determination of holding period

Under present-law requirements (sec. 246(c)(3)), the 16-day and 91-day holding period for the dividend received deduction do not include periods during which the taxpayer has sold short, has entered into a put option, or is under a contractual obligation to sell substantially identical stock or securities. It is unclear to what extent the holding period is suspended when the taxpayer has written a deep-in-the-money covered call option (*i.e.*, an option with a strike price that is substantially below the value of the security when the option is written) giving someone the right to buy the security, or otherwise reduce risk of loss on the securities through straddle transactions.

Administration Proposal

If the shareholder corporation does not hold stock for more than one year, the fair market value of extraordinary dividends (to the extent not subject to tax) would reduce its basis in the stock. Extraordinary dividends would include dividends received within any 90-day period with a fair market value equal to or greater than 10 percent (five percent in the case of preferred stock) of the taxpayer's basis in the stock. Extraordinary dividends would also include dividends received within any one-year period with a fair market value equal to or greater than 20 percent of the taxpayer's basis in the stock (common or preferred).

The one-year holding period (as well as the 15-day and 90-day periods under present law) would be limited to exclude any period during which the taxpayer is grantor of an in-the-money option with respect to the stock, or any period that the taxpayer's risk of loss is substantially diminished because of holding other positions. The Committee may wish to consider providing an appropriate exception for nondeep-in-the-money covered call options.

Finally, a corporate shareholder's holding period for dividends of property could not exceed its holding period for its stock in the distributing corporation.

c. Certain dividends received from regulated investment companies

Present Law

A regulated investment company (RIC) is not subject to Federal income tax to the extent it distributes its income to shareholders. If at least 75 percent of a RIC's gross income consists of dividends from domestic corporations, then the entire amount of the RIC's dividends to its shareholders is eligible for the 85-percent intercorporate dividends-received deduction (sec. 854). Taxpayers have organized RICs, expressly for corporate investors, to take advantage of the tax provision that permits the pass-through of interest income (taxable at a maximum rate of 46 percent) to corporations as tax-favored dividend income (the maximum rate on which is only 6.9 percent).

Possible Proposal

For RICs that are 50-percent owned by corporations, the requirement could be that at least 95 percent of a RIC's gross income consist of dividends from domestic corporations, to qualify the RIC's dividends for the dividends-received deduction.

d. Dividends received deduction compliance

Background

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.

Possible Proposal

The Committee could consider amending the existing dividend reporting rules to require brokers to separately identify payments that are made in lieu of a dividend from those that are made as dividends.

2. Ordinary Nonliquidating Dividend of Appreciated Property

Present Law and Background

Generally, a distribution of appreciated property by a corporation with respect to its stock is not a taxable event to the distributing corporation. As an exception to the general nonrecognition rule, taxable gain is recognized to the distributing corporation on distributions of appreciated property in certain redemptions. However, if the distribution is to a corporate shareholder and the distribution is limited to the basis of the property, the appreciation is not taxed to the distributor under this exception. Distributions of appreciated property in regular dividend transactions generally are not taxable events to the distributing corporation.

The nonrecognition rule applicable to ordinary dividends results in tax advantages associated with distributions of royalty trusts by oil and gas producers to their shareholders. Once producing oil and gas properties have been distributed, income from those properties is not subject to the double taxation that ordinarily applies to corporate-source income. Applying a tax on the appreciation upon distribution would ensure collection of the corporate-level tax, at least at the applicable rate. It should be noted, in connection with royalty trusts, that the Treasury does collect a tax from the individual shareholders on the value of the trust when it is distributed, and this tax offsets some of the revenue lost at the corporate level. The basis step-up to the shareholder of the interest may, thereafter, be recovered through the allowance of depletion.

Gain may not be recognized on redemptions of stock held by corporate distributees in certain transactions involving the distribution of a controlled subsidiary's stock that are economically comparable to sales of the stock, notwithstanding rules adopted in TEFRA to insure that gain would be taxed to a parent corporation in similar cases. If the controlled subsidiary satisfies certain active trade or business requirements and the parent distributes an amount of stock constituting 80 percent control of the subsidiary, the distribution may qualify for tax-free treatment even though the shareholder is a corporation that has purchased stock in the parent that is redeemed for the controlled subsidiary's stock in the transaction (sec. 355). The Internal Revenue Service may argue that, under present law, the transaction is a device for the distribution of earnings and therefore ineligible for non-recognition treatment.

There are several statutory exclusions from the requirement that gain be recognized to a distributing corporation distributing appreciated property in a redemption. These exclusions include redemption of stock to pay death taxes, certain redemptions of stock held by private foundations, and redemptions of regulated investment company stock. It is not clear that these exclusions provide appropriate criteria for distinguishing tax-free from taxable transactions.

In addition, as indicated above, gain recognition is not required in carryover basis redemptions of stock held by a corporate shareholder. The continued application of this exclusion may also be questionable. If gain is not recognized on distributions of royalty trusts to corporate shareholders, regardless of whether stock is redeemed, the gain-recognition rule may have little impact on these transactions.

Administration Proposal

Any ordinary, nonliquidating, distribution of appreciated property would be taxable to the distributing corporation. The exceptions of present law would remain.

Possible Additional Proposals

In addition, the Committee may wish to consider eliminating the exceptions of present law covering carryover basis transactions, redemptions to pay death taxes, redemptions of stock held by private foundations, and redemptions of regulated investment company stock.

The Committee may also wish to clarify present law treatment of tax-free distributions of stock in a controlled subsidiary. Present law could be clarified to provide expressly that nonrecognition treatment applies to the corporate parent on such distributions, but that gain will be recognized if the distribution is made to a corporate shareholder with respect to stock held by the distributee for less than 5 years.

3. Investment Companies that Accumulate Earnings

Present Law and Background

Certain investment companies are organized to be widely held by individual investors and to invest in dividend-paying stocks. The investment company itself pays no dividends. Rather, its shareholders hold the stock for at least a year and then sell it at a price that reflects dividends received and retained by the company. Their gains are generally long-term capital gains, so individual shareholders essentially recognize dividend income at a tax rate substantially below 50 percent. The company can avoid being treated as a mutual fund, or regulated investment company (RIC), simply by not electing to be treated as a RIC. (RIC treatment would result in tax exemption at the corporate level but current taxation of the company's income to the shareholder—who would not, unless they were corporations, qualify for the 85-percent dividends-received deduction.) The investment company's corporate income tax is small because of the 85-percent dividend received deduction. Further, relying on an interpretation of certain case law, the company may take the position that it is not subject to the accumulated earnings tax because it is widely held. Even if the investment company is subject to the accumulated earnings tax, it can substantially avoid tax by taking its capital losses and capital gains in different years since net capital losses, not deductible otherwise, are permitted as a deduction in computing the accumulated earning tax and can be used to offset the investment company's dividends that would otherwise result in imposition of the tax.

Administration Proposal

The accumulated earnings tax provisions would be amended to make clear that the mere fact that a company is widely held will not exempt it from the accumulated earnings tax. In the above example, the company would have to pay dividends to its shareholders taxable at ordinary income rates or be subject to a penalty tax under the accumulated earnings tax provisions. The deduction for net capital losses in computing the tax would be denied to mere holding or investment companies. The proposal would be effective for tax years commencing after date of enactment.

4. Short Sale Transactions

Present Law and Background

A short sale is a transaction in which an investor borrows stock (or other property), sells the stock and at a later date buys stock to repay the loan. The short seller profits if the stock declines in value between the time he sells the stock short and the time he acquires stock to repay the loan; he loses if the stock appreciates in that period. Gain or loss (usually short-term capital gain or loss) is measured by the difference between the amount received and the amount later paid to buy stock to return to the lender to close the short sale. As part of the transaction, the taxpayer will be obligated to pay the lender an amount equal to any dividends paid on the stock in the period between the borrowing and the return. Amounts paid by the taxpayer to the lender in lieu of such dividends are deductible against ordinary income by the taxpayer. Rev. Rul. 62-42, 1962-1 C.B. 133. As a result of these rules, a taxpayer can create short-term capital gain and an ordinary deduction in a transaction which has essentially no economic consequences.

Example.—Assume X Corporation, whose shares are trading at $10, has declared but not yet paid a dividend of $2 per share. A borrows 100 shares of X stock from broker B, and sells the shares short, receiving $1,000. On the dividend payment date, A must pay B $200 as a substitute for the dividend. Following payment of the dividend, the stock drops from $10 to $8 (reflecting the decrease in value of the shares from payment of the dividend). Thus, A may close the short position by buying 100 shares for $800, profiting $200 on the short sale—the profit corresponding exactly to the amount of the dividend substitute payment. Under Rev. Rul. 62-42, 1962-1 C.B. 133, the dividend substitute is allowed as an ordinary deduction under section 212. The corresponding gain on the short-sale transaction is short-term capital gain. For a taxpayer who has capital losses which would not otherwise be deductible, or for one who has short-term capital losses that would otherwise be deducted against long-term capital gains, such a conversion of ordinary income into short-term capital gains provides a significant tax benefit.

When corporations distribute large dividends, there is frequently considerable tax-motivated trading activity. For example, Chrysler recently distributed four years worth of back dividends on its preferred stock, an $11.69 dividend on stock selling for about $36. Even though only 10 million shares of the preferred are outstanding, the "short interest" of short sellers amounted to over 6 million shares and trading volume approached one million shares per day.

Administration Proposal

Payments in lieu of dividends (other than certain extraordinary dividends) would not be deductible against ordinary income unless the short sale is held open for at least 16 days. No deduction would be allowed for payments in lieu of extraordinary dividends (as described in section 1.6, above), unless the short sale is held open for at least one year and a day. The disallowed amounts paid to a lender of stock in lieu of dividends would be treated as part of the short seller's basis in the stock acquired to close the short sale, reducing the capital gain or increasing the capital loss on the short sale. A short sale would be considered as open only for periods during which the taxpayer is not protected against loss on the short position by holding another position. Payments in connection with short sales that are not capitalized under the proposal would be treated as interest for purposes of the present law rules limiting the deduction of investment interest and disallowing interest on debt incurred to purchase or carry tax-exempt interest.

5. Transfers of Partnership Interests by Corporations

Present Law and Background

Under present law, when a partnership interest is sold, any gain on the sale is treated as ordinary income to the extent the gain is attributable to certain ordinary income items (including depreciation recapture) of the partnership. Also under present law, when a corporation distributes property (or sells property in the course of certain complete liquidations), income attributable to recapture property is taxed to the corporation, while nonrecapture gain attributable to appreciation in the transferred property goes unrecognized.

Taxpayers have argued that the recapture provisions do 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 may avoid recapture by contributing recapture property to a partnership and distributing the partnership interest to its shareholders, or selling it in the course of liquidation.

Administration Proposal

In determining the extent to which gain is recognized to a corporation disposing of a partnership interest in a distribution or liquidating sale, the transaction would be treated as a distribution or sale of the corporation's proportionate interest in any partnership property which would result in recognition of gain. Gain would be recognized to the extent gain would have resulted on the disposition of the partnership interest. The rule would be applied by looking through partnership tiers.

6. Transactions Involving Foreign Corporations

a. Certain transfers of appreciated property to foreign corporations

Present Law and Background

U.S. citizens, residents, and corporations are generally subject to tax on their worldwide income. In contrast, the United States generally taxes foreign corporations only on their U.S.-source income and foreign-source income that is effectively connected with a U.S. trade or business. Because of the application of these rules taxpayers can defer U.S. tax on earnings derived through a foreign corporation until the earnings are distributed as dividends or the taxpayer disposes of the shares in the corporation. The advantage of using a foreign corporation to defer U.S. tax is enhanced when the corporation is organized in a tax-haven country that imposes little or no tax on the corporation's earnings.

In general, certain transfers of assets in corporate organizations, reorganizations, and liquidations can be made without recognition of gain to the transferor. However, under section 367, when a foreign corporation is the transferee, tax-free treatment is not available unless the Internal Revenue Service rules that the transfer does not have as one of its principal purposes the avoidance of Federal income tax. Under Internal Revenue Service guidelines issued in 1968, a favorable ruling is ordinarily issued with respect to transfers of assets (including intangible property) for use in the active conduct of a trade or business abroad. The guidelines also list certain "tainted" assets (such as inventory and accounts receivables) transfers of which are subject to tax.

Judicial interpretation of the principal purpose test has eroded the ability of the Internal Revenue Service to administer section 367. *See, e.g.*, *Dittler Bros* v. *Commissioner*, 72 T.C. 896 (1979), *aff'd mem.*, 642 F.2d 1211 (5th Cir. 1981) (the facts of which presented a serious case of tax avoidance). Also, the Internal Revenue Service's current ruling policy permits the tax-free transfer of intangible property overseas, where the development of the intangible property generated significant U.S. deductions and credits but the income from which may escape any U.S. taxation. Finally, the courts have rejected the Internal Revenue Service requirement that certain losses be recaptured on the incorporation of a foreign branch by a U.S. person (Rev. Rul. 78-201, 1978-1 C.B. 91 and Rev. Rul. 80-246, 1980-2 C.B. 125). *Hershey Foods Corp.* v. *Commissioner*, 76 T.C. 312 (1981), *appeal dismissed*, (3d Cir. 1981).

Administration Proposal

The proposal would amend the rules governing transfers of property abroad to provide that gain will be recognized, without regard to purpose, upon the transfer of appreciated property to a foreign corporation which is not for use in an active trade or business outside the United States. Certain transfers of assets containing built-in gain, outlined in IRS ruling guidelines, would automatically be subject to tax. Transfers of stock would be subject to the active trade or business test. Also, transfers of intangibles for less than full consideration would be subject to tax. Finally, the proposal would codify the present IRS ruling policy on incorporations of foreign branches.

b. Decontrol of foreign corporations

Present Law and Background

When a U.S. person who is a 10-percent shareholder of a controlled foreign corporation (CFC) sells or exchanges stock in a taxable transaction, any gain realized is treated as ordinary income to the extent of the shareholder's pro rata share of the CFC's previously untaxed earnings and profits. Certain transactions, however, may circumvent these rules. For instance, some have argued that where a CFC that is wholly owned by a widely held U.S. corporation, exchanges its newly issued shares for shares of the U.S. corporation, that transaction may not be treated as a sale or exchange by the U.S. corporation under section 1248. That interpretation would lead to permanent exemption from U.S. corporate tax of earnings of the foreign corporation accumulated prior to the exchange. It could also cause the foreign corporation to cease being a CFC for the future, thus insulating it from the anti-tax haven activity rules of the Code. Recently, in such a transaction, McDermott Incorporated became the subsidiary of its former Panamanian subsidiary.

Administration Proposal

The proposal would treat certain exchanges by a CFC of its newly issued stock for shares of the parent corporation as sales or exchanges by the U.S. parent of stock in the CFC. The proposal would apply only for purposes of section 1248. Thus, the parent could be subject to tax on some of the subsidiary's deferred earnings at ordinary income rates.

c. Recharacterization of U.S. income as foreign income

Present Law and Background

In general, the United States taxes all *U.S. income* of "United States persons."[13] The United States does *not* always tax all *foreign* income of United States persons.[14] These rules give some taxpayers an incentive to label income "foreign" rather than "U.S."

U.S. income includes, generally, dividends and interest paid by U.S. persons. It also includes income from insurance policies that cover risks in the United States. Dividends and interest that a foreign corporation pays are generally "foreign" income.

Taxpayers can place the "foreign" label on some non-business U.S. income by routing it through a foreign corporation. For example, a U.S. person may own 100 percent of a corporation in a tax haven country. That foreign corporation receives non-business U.S.

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[13] The term "United States persons" includes U.S. citizens, U.S. residents, U.S. corporations, and certain estates and trusts. The term "U.S. income" means income from sources within the United States (secs. 861, 863).

[14] That is, the foreign tax credit can offset U.S. tax on foreign income, but not on U.S. income. This rule is the Code's "foreign tax credit limitation".

income—perhaps from its U.S. owner. There may be little or no U.S. tax on the foreign corporation's income.[15] The U.S. person receives a dividend[16] from the foreign corporation. That dividend is "foreign" income. Therefore, it may escape U.S. tax (by increasing available foreign tax credits).

Possible Proposal

When over half the gross income of a foreign corporation is U.S. income, a possible proposal would be to treat some of the interest and dividends foreign corporation pays as U.S. income. This rule would apply only for purposes of the foreign tax credit limitation. This rule could be applied only if half its gross income is U.S. income over a three-year base period. Also, the interest and dividends that the foreign corporation pays could be treated as U.S. income to the extent that its gross income is U.S. income: e.g., if 75 percent of its gross income is U.S. income, then 75 percent of the interest and dividends it pays would be U.S. income.

d. Recharacterization of interest income as dividend income

Present Law and Background

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.

The United States' foreign tax credit can reduce U.S. tax on foreign income. In general, if a U.S. person pays no *foreign* tax on foreign interest income, however, the U.S. person must pay *U.S.* tax on that foreign interest income. The foreign tax credit will generally not offset the U.S. tax on that foreign interest income, no matter how high the foreign taxes on foreign *non-interest* income.[17] This rule preserves the U.S. tax on interest income of U.S. persons, wherever earned. Its purpose is to remove any tax advantage for lending abroad over lending in the United States. It prevents generation of low-taxed foreign income that can absorb foreign tax credits.

A U.S. person may circumvent this special rule by creating a foreign corporation that lends money (for example, through a bank deposit) and earns interest income. When the U.S. person is taxable on that income, it will *not* be interest income. The U.S. person will generally have income currently in the *amount* of the foreign corporation's interest income (under the Code's anti-tax haven activity rules (Subpart F)). The use of the foreign corporation will convert the *character* of the interest income to non-interest income, however.

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[15] Although U.S. persons are fully taxable on U.S. income, non-U.S. persons are *not* always fully taxable on U.S. income.

[16] The Code's anti-tax haven activity rules (Subpart F) sometimes treat the U.S. person as if it had received a dividend from a controlled foreign corporation. If so, that deemed distribution is foreign income, too.

[17] 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. This rule is a *separate* foreign tax credit limitation for interest income.

This newly recharacterized "non-interest" income is not subject to the rule governing interest income, so it may totally escape both U.S. and foreign tax (by increasing available foreign tax credits).

Possible Proposal

A possible proposal would be to treat a portion of a dividend from a foreign corporation as interest income if interest income amounts to 10 percent or more of the foreign corporation's earnings and profits for that year. The dividends that the foreign corporation pays could be treated as interest income to the extent that its earnings and profits arise from interest income: e.g., if 40 percent of its earnings and profits arise from interest, then 40 percent of the dividends it pays would be interest income. The same rule could apply to inclusions under the anti-tax haven activity rules of Subpart F. These rules would apply for purposes of the foreign tax credit limitation.

e. Use of territories to avoid U.S. tax on foreign investors

Present law and Background

Payments of U.S. source interest, dividends, and other passive income to foreign investors are generally subject to a 30-percent U.S. withholding tax. The United States does not impose withholding tax, however, on payments of passive income to corporations organized in Guam, the Commonwealth of the Northern Mariana Islands, or the U.S. Virgin Islands. Some taxpayers contend that passive U.S. source income can flow through such corporations to foreign investors 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" as appropriate ("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 income has a U.S. source. In these possessions, then, application of the "mirror Code" might indicate that interest and dividends paid by a corporation organized in the possession are not possession source income if less than 20 percent of the corporation's income is from sources in the possession. A possession subsidiary whose sole activity is lending money to its (non-possession) U.S. affiliate, according to some taxpayers, would earn only non-possession source income. Therefore, taxpayers have contended that payments of interest and dividends from such a corporation to a foreign investor are free of the 30-percent possession withholding tax. Temporary Treasury regulations, however, indicate that income derived from one of these possessions that is not subject to tax to the recipient there is U.S. source income. Under the mirror concept, then, income derived from the United States (such as interest paid from a U.S. corporation to a Guamanian finance subsidiary) that is not subject to U.S. tax to the recipient (because of U.S. rules exempting such income from tax) is possession source income. Therefore, the "80/20" rule does not apply, and the possession must impose a 30 percent withholding tax on payments from the local corporation to the foreign investor.

Possible Proposal

Interest, dividends, and other passive income paid from U.S. sources to corporations organized in Guam, the Marianas, or the Virgin Islands could be subject to U.S. tax if the direct or indirect beneficiaries are residents of foreign countries.

f. Source of shipping income

Present Law and Background

In general, the United States taxes all U.S.income, but not all foreign income, of United States persons. In general, the United States does not tax the foreign income of non-United States persons (such as foreign corporations). These rules give some taxpayers, both U.S. and foreign, an incentive to label income "foreign" rather than "U.S."

In general, income earned on the high seas is foreign income. In general, shipping income is U.S. income only to the extent of the time spent or the costs incurred within the United States and its territorial waters (the three-mile limit). Shipping income can be almost all foreign even if the voyage is between two U.S. ports or a U.S. port and a foreign port.

Possible Proposal

Income earned for shipping between U.S. ports could be treated as U.S. income. Income earned for shipping goods from one U.S. port to a foreign port for ultimate delivery to another U.S. port would be half U.S. and half foreign income. Similarly, income earned for shipping goods from a foreign port to a U.S. port would be half U.S. and half foreign income if the goods originated at a U.S. port. For example, a vessel takes oil from Alaska to the Pacific side of Panama. The oil flows through Panama in a pipeline. A second vessel takes the oil from the Atlantic side of Panama to New York. The income that each vessel earns would be one-half U.S. and one-half foreign. This change in the source rules would apply to both U.S. and foreign taxpayers.[18] The same rules would apply to income earned for air transportation and for use of containers.

g. Foreign collapsible corporations

Present Law and Background

Section 341 generally requires a shareholder's gain on the sale or liquidation of a collapsible corporation to be reported as ordinary income rather than capital gain. However, section 341(f) permits a shareholder to obtain capital-gain treatment on disposing of stock if the corporation consents to recognize gain on disposition of its noncapital assets when realized. Some taxpayers may take the position that a foreign corporation can give a section 341(f) consent to

[18] The basis of this proposal is H.R. 4561, introduced by Mr. Shannon and Mr. Bedell.

circumvent section 341, because enforcement of the consent would become impractical if the stock is sold to a foreign person.

Possible Proposal

The Committee may wish to consider clarifying present law by expressly prohibiting section 341(f) consents by foreign corporations.

7. Brother-sister Controlled Group of Corporations

Present Law and Background

Certain tax advantages can be achieved by operating what is essentially a single economic enterprise through multiple corporations (*e.g.*, the income of a single enterprise could be spread among affiliated corporations to the extent necessary to qualify each corporation to compute a tax on a portion of the combined income under the graduated rate brackets applicable to corporate taxable income not exceeding $100,000). However, a number of statutory provisions limit the extent to which a controlled group of corporations can achieve these tax advantages.

The term "controlled group" is defined by statute to include two or more corporations if five or fewer persons own 80 percent (by vote or value) of each corporation, and more than 50 percent (by vote or value) of each corporation determined by taking into account stock interests only to the extent that they are identical in such corporation. Treasury regulations provide that the 80-percent test is satisfied if five or fewer persons own, singly or in combination, stock possessing at least 80 percent of vote or value. However, in *U. S.* v. *Vogel Fertilizer Co.*, 455 U.S. 1016 (1982), the U.S. Supreme Court rejected the regulations as invalid, holding that a shareholder must own some stock in each of the brother-sister corporations to be counted for purposes of the 80-percent test.

Example.—In the *Vogel Fertilizer* case, one shareholder owned 77 percent of one corporation and 87 percent of another. A single shareholder owned 23 percent of the first corporation but none of the second. It is clear that the identical ownership requirement of the 50-percent test, which requires common ownership, was satisfied. If the 80-percent test also imposes a common ownership requirement, then the 50-percent test has no significant independent function.

Possible Proposal

The Committee may wish to consider amending the statutory definition of controlled group could be amended to eliminate the 80-percent test.

The Committee may also wish to consider amending another related problem, the ability to use convertible preferred stock to avoid consolidation, by changing the definition of "affiliated group" (section 1504(a)) to require 80 percent of the equity as well as stock in order to consolidate inappropriate cases.

8. Transactions in Stock Warrants

Present Law and Background

Present law is unclear regarding the tax consequences to a corporation that issues warrants for the purchase of its stock. Under a statutory provision, no gain or loss is recognized to a corporation on the receipt of money or property in exchange for its stock (including treasury stock) (sec. 1032). Thus, the payment received for a stock warrant is nontaxable if the warrant is exercised. The Internal Revenue Service has taken the position that the lapse of a warrant is a taxable event, with the result that a corporation recognizes income on the lapse of a warrant with respect to its stock and recognizes any loss sustained when it reacquires the warrant. However, because case law may support nonrecognition treatment to the issuing corporation on expiration or repurchase of its warrants, corporations are able to claim losses and exclude income derived from the sale of their warrants. The uncertainty in present law effectively permits a corporation to elect between nonrecognition of gains or the generation of noneconomic (but deductible) losses.

Example.—Chrysler issues to the Treasury (in exchange for loan guarantees) warrants to buy 15 million shares of its stock at a price of $13 per share, at a time when Chrysler stock is selling for only $6 per share and the warrants are considered virtually worthless. Subsequently, Chrysler recovers and its stock price increases to $27 per share. Treasury decides to sell the warrants. The highest bidder is Chrysler itself, who buys the warrants at $18 per warrant ($270 million). Under present law, Chrysler claims a loss of $270 million. If, instead, someone else had bought the warrants and exercised them, Chrysler would have received no loss deduction.

Alternatively, if Chrysler had issued the warrants for a premium of $2 and the warrants lapsed, Chrysler might have taken the position that it need not recognize gain on the lapse of the warrants. If Chrysler stock had risen only to $14, the warrants would have been exercised and Chrysler would not have to report its $1 gain as income.

Possible Proposals

The American Bar Association has recommended the adoption of a rule that there be no inclusion in a corporation's income as a result of lapse or reacquisition of a warrant and that the basis of assets be reduced by the amount excluded. The ABA proposal does not deal with losses sustained on the reacquisition of its warrant by a corporation.

Under an alternative proposal, no gain or loss would be recognized to a corporation on any transaction with respect to an option to buy or sell its stock (including treasury stock).

9. Exchange of Debt for Stock

Present Law and Background

Under present law, income is realized when indebtedness is forgiven or in other ways cancelled (sec. 61(a)(12)). For example, if a corporation issues bonds at par and later repurchases the bonds at less than par, the difference is taxable at that time. Present law (sec. 108) provides that income from the discharge of indebtedness of a corporation may be excluded from income if the corporation reduces the basis in depreciable property. This allows the corporation to, in effect, defer the income. Special rules also apply to corporations which are insolvent or in bankruptcy.

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. This exception was grounded on the theory that the stock was simply a substitute liability for the debt and that no event occurred which should cause the recognition of income. However, the exception is applied notwithstanding that the stock may be substantially different than the debt obligation, or that the value of the stock issued is less than the debt cancelled.

The effect of this exception is to treat a corporation differently where it issues stock to discharge its debts than where it raises new capital by a stock issuance and uses that capital to discharge its outstanding debts, which would give rise to income from the discharge of indebtedness. It also allows a corporation to retire existing indebtedness for stock and then issue new indebtedness with a lower principal amount and a higher interest rate. This allows the corporation a larger interest deduction notwithstanding that the total payments (principal and interest) may have remained unchanged.

Possible Proposal

The Committee may wish to consider limiting the scope of the "stock for debt" exception to situations involving financially troubled corporations.

10. Earnings and Profits

a. Nontaxable ordinary distributions

Present Law and Background

Distributions by a corporation to its shareholders constitute dividends only to the extent of the corporation's earnings and profits. While all distributions are out of earnings and profits to the extent thereof, it is possible to distribute to shareholders amounts derived from increases in corporate wealth that have not been included in either taxable income or earnings and profits at the corporate level. To the extent such distributions exceed current and accumulated earnings and profits of the corporation, they reduce the shareholders' bases for their stock and any excess over stock basis generally is treated as capital gain.

Earnings and profits are not well defined by current law. Indeed, the term may not lend itself to ready definition. Furthermore, in many instances a corporation may have economic earnings but no earnings and profits for tax purposes. In such an instance, the corporate laws of most states would permit dividends to be paid, but such dividends would be treated as a return of capital under the Internal Revenue Code.

Possible Proposals

The Committee may wish to consider a suggestion that distributions by domestic corporations to their shareholders should receive ordinary income treatment. See *The Reform and Simplification of the Income Taxation of Corporations*, Sen. Finance Comm., September 22, 1983, p. 77. Under this suggestion, all distributions by domestic corporations which are not treated as sales or exchanges would be treated as dividends, with perhaps limited exceptions. This would bring the tax law into closer harmony with the corporate laws of most states.

Alternatively, the Committee might wish to attempt to define earnings and profits to more nearly resemble economic income. This would also bring the tax law more into conformity with general corporate laws. A number of provisions could be considered in this regard including but not limited to: treating currently untaxed income from sales reported on the installment basis to increase earnings and profits currently; increasing earnings and profits by any untaxed appreciation in the value of property distributed to shareholders; requiring capital expenditures which may, by election, be deducted currently or amortized over a short period of time to be capitalized for purposes of determining earnings and profits; requiring taxpayers on the completed contract method of accounting to accrue earnings and profits currently; and not permitting percentage depletion in excess of cost depletion, or bad debt reserves to reduce earnings and profits.

b. Distribution of debt by a corporation

Present Law and Background

Earnings and profits of a corporation are reduced by the principal amount of its obligations distributed to shareholders (sec. 312(a)(2)). Generally, for noncorporate shareholders, the amount of a distribution taken into account is the fair market value of the property distributed. A long-term obligation bearing little or no stated interest may have a present fair market value well below its stated redemption price. The result may be to eliminate corporate earnings and profits at the cost of a relatively small dividend to shareholders.

Further, accretions in value of the obligation through the passage of time are not taxable to the shareholders until the obligation is sold or redeemed, unless such amounts constitute original issue discount includible in income pursuant to the rules of section 1232A. When the increase in value of the obligation is realized by the shareholder, it generally will constitute gain from the sale or exchange of a capital asset (section 1232(a)) assuming it was not included in income over the term of the obligation as original issue discount. Original issue discount is defined as the difference between the issue price and the stated redemption price at maturity (sec. 1232(b)(1)). Since arguably there is no "issue price" when a corporation distributes its obligation as a dividend, the original issue discount rules may be inapplicable.

There appears to be no taxable consequences to the distributing corporation at the time of the distribution. Even if, as proposed above, the requirement that gain be recognized to a distributing corporation on the distribution of appreciated property in a redemption is expanded to include nonredemption distributions, that requirements exempts distributions by a corporation of its own obligations. Further, if the obligation is not subject to the original issue discount rules, the distributing corporation may contend that it is entitled to deduct the difference between the fair market value of the obligation and its redemption price on a straight-line basis rather than the less favorable rate applicable under sec. 163(e) to original issue discount. Earned discount was described as the functional equivalent of stated interest in *United States v. Midland-Ross Corporation* 381 U.S. 54 (1965) and the corporate distributor may contend that the difference between the obligation's value when issued and its redemption price is deductible as interest over the bond term.

Possible Proposal

The earnings and profits rules could be amended to provide that earnings and profits are reduced only to the extent of the fair market value of the corporation's debt distributed to its shareholders. Also such obligations could be made subject to the original issue discount rules of sections 1232A and 163(a). Alternatively, the distributed instruments could be treated as equity, resulting in no gain recognition to shareholders (sec. 305(a)). The instruments would be treated as other than common stock and therefore, their sale or redemption would result in ordinary income treatment under sec. 306. There would be no reduction in corporate earnings and profits prior to redemption and no deduction for claimed discount or interest would be available to the corporation.

11. Multiple-class Grantor Trusts

Background

The economic components of stock ownership are the yield and the opportunity for appreciation. In at least one recent transaction, taxpayers have attempted to separate these components in a manner that provides a yield (in the form of dividends) to corporate shareholders and appreciation rights to noncorporate taxpayers. In that transaction, AT&T securities were transferred to a trust, the trust then issued two different types of securities: a "prime" piece and a "score" piece. The parties to the transaction contemplate that the holders of prime pieces will be entitled to receive dividends and to recover the cost of their interests. Thus, if this scheme works, corporate holders could receive dividend income (subject to tax at a maximum rate of only 6.9 percent) without bearing the full risks of ownership. Each score piece represented a right to share in any appreciation in value for a term of 5-7 years. As such, the score pieces are the economic equivalent of call options to purchase the underlying stock. The holder of a score piece could realize any appreciation in value by selling the interest, paying tax at capital gain rates.

Possible Proposal

The Committee may wish to consider a provision that a shareholder that does not have all the incidents of ownership with respect to stock is not entitled to the dividend received deduction. Alternatively, multiple-class grantor trusts could be treated as associations taxable as corporations.

12. Redemptions Through Use of Related Corporations: Corporate Shareholders

Present Law and Background

Section 304 of the Code provides that if a shareholder of a 50-percent owned corporation transfers stock of that corporation to another 50-percent owned corporation in exchange for property, the transaction is treated as a redemption of the shareholder's stock in the acquiring corporation. (The transferred stock is considered to have been transferred by the shareholder as a contribution to the capital of the acquiring corporation.) In determining the tax consequences of the deemed redemption, dividend treatment results unless the transaction results in a termination or substantial reduction in the proportionate interest of the redeeming shareholder (sec. 302). The amount treated as a dividend is computed by reference to the earnings and profits of the acquiring corporation. The application of these rules to cases involving transfers by corporate shareholders presents numerous opportunities for tax avoidance.

Section 304 was designed to prevent shareholders from drawing off accumulated earnings and profits at capital gain rates, through the device of having a subsidiary corporation purchase the stock of its parent corporation from the shareholders of the parent. In enacting section 304, Congress recognized that, if the shareholders of a corporation obtain cash from the corporation's subsidiary, in effect, they have received a dividend to the same extent as would be the case if the cash had been paid by the subsidiary to the parent and then distributed to the shareholders. The application of section 304 to noncorporate taxpayers could result in the treatment of what would be capital gain (taxable at a maximum rate of 20 percent) to dividend income (taxable at a maximum rate of 50 percent). However, for corporate taxpayers whose capital gains are taxed at a maximum rate of 28 percent, the transmutation into tax-favored dividend income is a benefit.

Another issue presented by the application of section 304 to corporations involves the computation of dividend income where the acquiring company has little or no earnings and profits. Prior to enactment of TEFRA, even if section 304 applied and dividend treatment resulted, it was possible for noncorporate taxpayers to obtain capital-gain treatment by selling stock to a corporation that had no earnings and profits. To preclude the use of this device, TEFRA included a provision that was designed to provide dividend treatment to the extent of the aggregate earnings and profits of both corporations. However, commentators have taken the position that the result of applying the TEFRA provision is that the earnings and profits of the acquired corporation are reduced by the amount treated as a dividend. This result would be particularly troublesome in the case of controlled foreign corporations with previously untaxed earnings and profits. In contrast, if there is no reduction of the acquired corporation's earnings and profits, while noncorporate taxpayers would not fare well, corporate taxpayers would be able to withdraw double the amount of combined earnings and profits without any basis reduction.

A technical amendment is included in H.R. 4170 that would clarify that the TEFRA provision would have no effect on the earnings and profits account of the acquired corporation as long as the acquiring corporation has sufficient earnings. However, this amendment would not obviate the issue in the foreign area because it would still be possible to avoid tax on previously untaxed earnings by using an acquiring corporation that has no earnings and profits.

Possible Proposal

The Committee may wish to consider limiting the application of section 304 to redemptions involving noncorporate taxpayers.

13. Taxes of a Shareholder Paid by the Corporation

Present Law

If a corporation pays a tax imposed on a shareholder on his interest as a shareholder, present law allows a deduction to the corporation rather than the shareholder whose tax is paid (sec. 164(e)). This rule is inconsistent with the general rule that taxes are deductible only by the person on whom they are imposed. The provision was originally adopted to provide a deduction to banks that voluntarily paid local taxes imposed on their shareholders, but operates to permit corporations to pay a deductible dividend. See *Hillsboro National Bank v. Commissioner* 457 U.S. 1103 (1983). Sec. 164(e) could be repealed.

Possible Proposal

The Committee may wish to consider the repeal of section 164(e). If section 164(e) is repealed, a corporation's payment of a tax imposed on a shareholder would be treated as a taxable dividend to the shareholder.

14. Distributions in Liquidation

Background

Except for recapture income, LIFO inventory reserves and certain installment obligations, no gain is recognized to a corporation on a distribution of property in a complete liquidation of the corporation. Nonrecognition treatment also extends to property sold in the course of a complete liquidation. The present rules generally require the recognition of items resulting in ordinary income to the corporation with the exception of inventory (other than LIFO inventory) and certain receivables. The income derived from inventory and other ordinary income items constitutes operating profits as distinguished from gain from the liquidation of plant, equipment and other capital items.

Possible Proposal

The requirement that income be recognized to a liquidating corporation could be extended to distributions and sales of all items constituting ordinary income assets to the corporation.

15. Use Of Multicompany Structure To Reduce Tax On Coal Operations

Present Law and Background

Present law (sec. 631(c)) provides that, subject to certain special computations, 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. In the case of iron ore (but not coal), capital gain treatment is also not applicable to a disposal 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 ore.

Where 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 (sec. 631(c)).

Under present law, it may be 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 would be deductible by the operating company, and the amount of the royalties received by the land company (after subtracting cost depletion and certain expenses) would qualify 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 would be reduced.

Possible Proposal

Section 631(c) would be amended 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.

16. Inside Basis Adjustment on the Acquisition of a Corporation in an Involuntary Conversion

Present Law and Background

Gain realized by a taxpayer from the involuntary conversion of property (i.e., by destruction, theft, seizure, or condemnation) is not recognized if the property is replaced by property similar or related in service or use (section 1033). The property may be acquired directly or by acquiring 80 percent control of a corporation owning the replacement property. The basis of the replacement property generally is the same as the basis of the converted property, reduced for proceeds not expended for the replacement property. This basis requirement does not affect the basis of assets held by a corporation when the taxpayer satisfies the replacement requirement by acquiring control of that corporation. This difference in tax treatment between acquiring replacement property and stock of a corporation owning replacement property can lead to tax avoidance.

Assume, for example, that a taxpayer owns a building with a low basis ($100) and a high fair market value ($1,000), the building is destroyed by fire, and the taxpayer receives insurance proceeds equal to the fair market value ($1,000). The taxpayer then finds a similar building that is the sole asset of a corporation, and the taxpayer is able to acquire all the stock of that corporation for a price equal to the insurance proceeds ($1,000). Assume further that the basis of the building in the hands of the corporation is $800. If the taxpayer purchases the building directly, his basis will be his former basis in the old building ($100). If, however, he purchases the stock of the corporation, the basis of the building to the corporation remains the same as it was before the acquisition ($800). Thus for example, the taxpayer could cause the corporation to sell the building and limit the taxable gain to the difference between the sales price and the basis of the new building in the hands of the corporation rather than his basis in the old building.

Possible Proposal

The Committee may wish to consider providing that when the acquisition of stock results in nonrecognition of gain to a taxpayer because of an involuntary conversion, the basis of corporate assets would be reduced by the amount of any unrecognized gain on the conversion of the involuntary converted asset.

C. TIME VALUE OF MONEY AND OTHER ACCOUNTING ISSUES

The time value of money is generally the difference in value between a right to an amount today and a right to the same amount at some time in the future. The right to $1 today is worth more than the right to $1 ten years from today, by the amount that could be earned by investing $1 for ten years. In many instances, the Code ignores, or fails to properly account for, 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. Although recent legislation provided for the economic accrual of original issue discount arising on the issuance of certain debt obligations, there is no similar statutory requirement for the economic accrual of interest on deferred payments for the sale or exchange of property other than securities traded on an established securities exchange.

Many tax shelter transactions enable taxpayers to obtain substantial unintended tax benefits by exploiting the Code's failure to take into account the time value of money. The exploitation of this deficiency in the Code has increased significantly as a result of the high interest rates of recent years.

Computation of interest in deferred payment transactions

This section presents, first, a discussion of deferred payment transactions in which a more rational accounting for interest appears to be required; second, a discussion of the proper time to accrue a deduction for an expense where a liability arises currently in connection with a payment to be made in the future; and third, a discussion of the potential for tax shelters to accelerate deductions by prepaying expenses.

1. Deferred Payment Transactions

Present Law and Background

When property is sold and the parties agree to defer payment of all or a portion of the purchase price, a loan transaction has occurred in conjunction with the sale. The seller has lent the purchaser the difference between the purchaser's down payment, if any, and the amount the seller would have accepted for the property if the full amount had been paid at the time of sale. The terms of this purchase money loan may not be expressly stated in the sales contract. For example, the contract may simply require payment of stated amounts on specified dates, with no designation as to which portion of a payment is attributable to principal (*i.e.,* is intended to reimburse the seller for the property) and which portion is attributable to interest (*i.e.,* is intended to compensate the seller for the forbearance of the use of money).

Generally speaking, if the contract specifies a current market rate of interest and requires the purchaser to pay interest on the outstanding loan balance at least annually, there is little or no distortion in the taxation of the parties. The seller's gain on the sale, the purchaser's basis for the property, the seller's interest income, and the purchaser's interest expense for Federal income tax purposes follow the actual economics of the transaction. However, when the contract states an inadequate interest rate or does not require payment of the interest on a current basis, the purchase price of the property has been overstated.[20] What are in economic reality interest payments will have been recharacterized as payments of sales price, or loan principal.

This recharacterization of interest as sales price, although of no economic significance to the parties, may have important tax consequences. If the property sold was a capital asset to the seller, the seller will have transformed interest income (which should be taxable currently as ordinary income) into capital gain (which is taxable at lower rates and whose taxation is generally deferred until paid). Property that is depreciable in the hands of the purchaser will have an artificially high tax basis, resulting in overstated cost recovery deductions and investment tax credits. The cost recovery deductions available to the purchaser under the accelerated cost recovery system (ACRS) may more than offset the reduced interest deductions attributable to the use of a below market rate of interest. In some cases, the present value to the purchaser of the ACRS deductions and investment credit may far exceed the present value of the obligation to pay the seller amounts in the distant future.

Regardless of the amount of interest payable under a deferred payment sales contract, distortions to the taxation of the parties may occur if the contract does not call for interest to be paid currently. Failure to require payment of interest at least annually may result in a mismatching of the interest income reported by the seller and the corresponding interest expense claimed by the purchaser, where the seller reports income on the cash method and the purchaser on the accrual method. While the accrual method purchaser deducts the interest payable on a current basis, the cash method seller does not include this amount in income until it is received in a subsequent period. The present value to the government of income included by the lender in the subsequent period will be less than the present value of the deductions claimed by the purchaser. As the disparity between the time when the purchaser deducts the interest expense and the time when the seller reports the interest income increases, the cost to the government increases geometrically.

The distortion to the taxation of the parties is magnified if the accrual method purchaser computes its interest deduction using a noneconomic formula, such as straight-line amortization, simple in-

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[20] To illustrate how an understatement of the interest element of a transaction overstates the purchase price, assume a sale of property with a value of $100 and an actual market interest rate of 12 percent. Buyer agrees to pay and seller agrees to accept $179 at the end of 5 years (consisting of $100 principal and $79 interest). The parties could, by artificially stating an interest rate on the sale of 9 percent compounded semiannually, fix the principal amount at $115 ($179 discounted to present value at a rate of 9 percent is approximately $115). If recognized for tax purposes, the purported principal amount would overstate the value of the property by $15.

terest, or the "Rule of 78's".[21] This has the effect of overstating the interest accrual in the earlier years of the loan, thus accelerating the purchaser's deductions. An economic accrual formula would take into account the compounding of interest, that is, the fact that more interest economically arises in the later periods because the amount of the debt is increased by the accrued but unpaid interest from earlier periods.

The Internal Revenue Service recently issued a revenue ruling which proscribes the deduction of interest in an amount in excess of the amount of the economic accrual of interest for the taxable year. In Rev. Rul. 83-84, 1983-1 C.B. 9, the Service ruled that the amount of interest attributed to the use of money for a period between payments must be determined by applying the "effective rate of interest" on the loan to the "unpaid balance" of the loan for that period. The unpaid balance of the loan is the amount borrowed plus the interest earned, minus amounts previously paid. The effective rate of interest is a measure of the cost of credit, expressed as a yearly rate, that relates the amount and timing of values received to the amount and timing of payments made; it is thus a reflection of the cost of the amount borrowed for the time it is actually available. The effective rate of interest, which is a uniform rate over the term of the loan and is based on the amount of the loan and the repayment schedule, will produce the true cost of the amount borrowed when applied to the unpaid balance of the loan for a given period. Rev. Rul. 83-84 does not apply to certain short-term consumer loans that require level payments of interest at regular intervals at least annually.[22]

Although Rev. Rul. 83-84 is consistent with present-law rules for computing original issue discount (under secs. 1232A and 163(e)), generally accepted accounting principles, and sound economic theory, the ruling may be challenged by taxpayers.[23] It is understood that a number of taxpayers are, on advice of counsel, failing to comply with its mandate.

Original issue discount rules

Concern over the mismatching of interest income and deductions by lenders and borrowers in loan transactions led to the enactment in 1969 of provisions requiring ratable inclusion in income of "original issue discount" (OID) by the holder of a debt obligation. OID arises when a borrower receives less from the lender than the amount that must be repaid to the lender. The difference between the issue price of an obligation (the amount received by the borrower) and its stated redemption price performs the same function as interest; it compensates the lender for the use of its money.[24]

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[21] The Rule of 78's is a formula for allocating interest over the term of a loan that results in much larger deductions in the early years. To illustrate, in the case of a 30-year loan, interest would be calculated under the Rule of 78's by first taking the sum of the integers from 1 through 30 (*i.e.*, 1+2+3+4.... and so on up to 30), or 465. The borrower would accrue 30/465 (or 6.45 percent) of the total interest in the first year, 29/465 (6.24 percent) in the second year, and so on until the 30th year when 1/465 (.22 percent) of the interest would be accrued.

[22] Rev. Proc. 83-40, 1983-1 C.B. 774.

[23] *C.f., James Bros. Coal Co. v. Commissioner*, 41 T.C. 917 (1964), *appeal dismissed per stipulation* (6th Cir. 1964).

[24] See *United States v. Midland Ross Corporation*, 381 U.S. 54 (1965) (a case that arose under the 1939 Code).

The 1969 amendments to the Code required OID to be taken into account annually by both lenders and borrowers, regardless of their accounting method. Under these provisions, borrowers were allowed to deduct OID on a straight-line basis over the life of the loan, resulting in interest deductions larger in the earlier years than justified under an economic accrual formula. Lenders were correspondingly required to report a disproportionately large amount of interest income in the early years of the loan.

In recognition of the shortcomings of these rules, further amendments were made to the OID provisions in 1982. Under the 1982 rules, reporting of OID on a constant interest basis is required of both issuers and holders of obligations subject to the OID rules. Thus, OID must be allocated over the life of the bond through a series of adjustments to the issue price for each "bond period" (generally, each one-year period beginning on the date of issue of the bond and each anniversary thereof). The adjustment of the issue price for each bond period is 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 bond's yield to maturity, and then subtracting the interest payable during the bond period. The adjustment of the issue price for any bond period is the amount of the OID allocated to that bond period.

The present rules for the treatment of OID do not apply to obligations issued by a natural person,[25] obligations that are not capital assets in the hands of the holder, or obligations issued in exchange for property where neither the obligation nor the property received is publicly traded.[26] The failure to include discount obligations issued for nontraded property where the obligations were themselves not traded resulted from the perceived difficulty in these situations of determining the issue price of the obligation (*i.e.*, the value of the property sold) and, therefore, the amount of the OID implicit in the obligation.[27] If the value of property is not readily ascertainable, the allocation between principal and interest on the obligation becomes uncertain.

Imputed interest on deferred payment sales of nontraded property

Parties to a deferred payment transaction involving a sale of property not within the OID rules may nonetheless be subject to the unstated interest rules of section 483. If the parties to such a transaction do not specify a minimum (safe harbor) rate of interest

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[25] Prior to 1982, the OID provisions applied only to corporate and taxable government obligations. The 1982 rules extended these provisions to non-corporate obligations other than those of individuals.

[26] It is unclear whether the economic accrual rules under section 1232A and the coupon stripping rules under section 1232B apply to foreign investors.

[27] The bill as originally reported by the House Ways and Means Committee and the Senate Finance Committee included within its scope 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. See letter from John S. Nolan, Deputy Assistant of the Secretary of the Treasury, to Sen. John J. Williams (dated November 28, 1969), 115 Cong. Rec. 36730-36731 (1969). 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, acknowledged the continued existence of the mismatching problem in transactions involving nontraded property, and stated that further corrective 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).

to be paid by the purchaser, section 483 imputes interest at a rate periodically set by the Treasury Department. Neither the safe harbor interest rate (also fixed by the Treasury) nor the imputed rate varies according to the length of time over which deferred payments are made or the maturity of the deferred payment obligation. Currently, the safe harbor rate is 9 percent simple interest. The imputed rate is 10 percent, compounded semiannually.

If interest is imputed under section 483, a portion of each deferred payment is characterized as interest. The allocation between interest and principal is made on the basis of the relative amounts of the payments, without regard to the time that has elapsed since the sale. Amounts treated as interest under section 483 are included in the income of the lender in the year in which the payment is received (in the case of a cash method taxpayer) or due (in the case of an accrual method taxpayer). The borrower likewise deducts this imputed interest in the year in which payment is made or due.

The simple interest safe harbor rate under present law does not represent an economic rate of interest for three reasons. First, although the safe harbor and imputed interest rates have changed over the years, they have not kept up with market interest rates. Second, a simple interest computation ignores the compounding of interest on unpaid interest which occurs as an economic matter. For example, a debt obligation bearing a stated rate of 9 percent simple interest payable at the end of 30 years actually bears interest at a rate of 4-1/2 percent on a constant interest basis. The use of a simple interest safe harbor rate may allow taxpayers to avoid imputation of interest under 483 even though the stated interest is significantly below prevailing market rates. Finally, the use of a single rate for all obligations regardless of the length of maturity fails to reflect the fact that lenders typically demand different returns depending on the term of the loan.

As explained above, understatement of the interest element of a deferred payment transforms what is in reality interest into principal or sales price, with a resulting overstatement of the tax basis of the property purchased. In such a case, the purchaser is able to claim excessive ACRS deductions and investment tax credits. These deductions and credits may have a materially higher present value than the interest deductions that would be available if an economic rate of interest were provided. Tax shelters have taken advantage of the low safe harbor rate provided under section 483 to obtain excessive ACRS deductions and investment credits.

Tax shelters have also exploited the method of allocating unstated interest among payments by structuring sales transactions so as to accelerate several years' interest charges into the year of the sale. For example, assume property with an established fair market value of $100,000 is sold for $2,500 in cash and two notes, one obligating the purchaser to pay $100,000 six months and one day after the sale, the other obligating the purchaser to pay $100,000 at the end of 30 years.[28] Since the notes have no stated interest, section 483 imputes interest at a rate of 10 percent, compounded semiannually. Applying this rate, the total unstated interest in the de-

[28] The present value of the cash and the notes, assuming the market rate of interest is 12 percent, would be approximately $100,000.

ferred purchase contract is $99,408 (the $200,000 face value of the two notes less $100,592, the sum of their present values). Since the deferred payments are made in two equal installments, the total unstated interest of $99,408 is allocated under section 483 one-half (*i.e.*, $49,704) to the first note and one-half to the second. Thus, the purchaser in this example is arguably[29] 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 is paid in the second payment.[30] The major portion of the purchase price is reflected in the payment of the first note, since the payment due in 30 years discounted at a market rate of interest has little present value (slightly more than $3,000 in this example).

Deferred payment transactions not involving the sale of property

The OID and imputed interest rules of present law do not apply to deferred payment transactions not involving the sale of property. The rules do not apply to a contract for the performance of services or the use of property where payment is not required until after the services have been rendered or the use of the property has occurred.[31] Deferred payment service contracts generally do not provide the same opportunity for overstatement of tax basis as contracts involving sales of property, since the cost of services is generally not treated as a capital expenditure. However, such contracts may permit a mismatching of the income reported by the service performer or lessor and the deductions claimed by the service recipient or lessee. For example, an accrual method lessee may be able to deduct rentals payable on a deferred basis ratably over the life of the lease while the cash basis lessor reports no income until the year the rent payment is actually received.

Administration Proposal

Under the Administration's proposal, the mismatching and noneconomic accrual problems presented by many of the transactions described above would be eliminated by extending the OID rules to debt obligations issued for nontraded property and which are themselves not publicly traded, including obligations issued in a reorganization. They would also apply to obligations issued for services or the use of property if payment is not reasonably expected to occur before the close of the calendar year following the calendar year in which the services will be performed or the property used. The proposal would also repeal the exceptions to the OID rules for obligations issued by natural persons and obligations held as noncapital assets. The proposal generally would extend the economic accrual and coupon stripping rules to foreign investors. The exception for

[29] It is possible that the rules that restrict deductions for prepaid interest may apply to limit the amount of the interest deduction in this situation.

[30] Although the section 483 rules would otherwise require the seller to recognize the same ordinary income of $49,704 in the year of payment, the seller may be able to avoid this result by disposing of the first note within six months of the sale.

[31] Payments made to employees and nonemployees pursuant to nonqualified plans of deferred compensation are governed by section 404, which denies a deduction for such amounts until the year in which they are included in the income of the employee. (In the context of qualified plans, accruals are allowed as a matter of policy for deferred compensation even though there is no current income inclusion by the employee.) Present law is unclear as to whether all deferred payments for services are within the scope of section 404.

discount obligations with a maturity of one year or less would be retained.

The proposal would solve the valuation problem inherent in non-traded property transactions by assuming a rate of interest in appropriate cases. In deferred payment sales transactions (other than those in which the obligation is issued for publicly traded property or is itself publicly traded, in which cases the market value of the traded side of the transaction will continue to determine issue price), a test rate similar to the safe harbor rate provided in existing section 483 would be applied to the transaction to determine whether adequate interest is provided. The applicable test rate would be a compound rate and would vary according to the maturity of the obligation (*e.g.*, short, medium, or long-term). The test rates would be adjusted semiannually. A conforming change would be made in the safe harbor interest rates on loans between related parties under section 482.

If an obligation failed to state adequate interest or to require annual payment of interest at least at the safe harbor rate, interest would be imputed annually at a higher rate, which would also be a compound rate based on the maturity of the obligation. The effect of the provision would be to fix the principal amount of the loan (and the sales price of the property or services) by assuming an interest rate approximating a market rate in cases where the issue price of an obligation is uncertain and the parties have failed to provide for adequate interest in the transaction. Interest imputed under this provision would be taken into account under the periodic inclusion and deduction rules of existing sections 1232A and 163(e).

Exceptions to the expanded OID rules would be provided for (1) the sale of a farm by an individual or closely held business where the sales price does not exceed $1 million, (2) the sale of a principal residence by an individual, and (3) a sale involving total payments of $250,000 or less. Payments constituting deferred compensation covered by section 404, payments described in section 83, and payments for services and for the use of property described in section 267, would also be exempted from these rules.

Since the scope of the OID rules would be significantly expanded under the Administration proposal, the scope of section 483 accordingly would be reduced. Under this new framework, section 483 would apply only in the case of transactions exempted from the revised OID rules (*e.g.*, sales of principal residences). In these cases, interest would be imputed unless adequate interest were stated in the obligation. Even if interest were imputed, however, annual recognition of interest income by the lender and deduction of interest expense by the borrower on an economic accrual basis would *not* be required in the manner provided under the OID rules. The timing of interest income or expense (whether stated or imputed) would be determined under present law.

Under the proposal, the section 483 interest rate structure would be revised to conform to the new section 1232A structure. That is, it would apply compound safe harbor and imputed interest rates which would vary according to the maturity of the obligation and would be adjusted at six-month intervals. The maximum rate of 7 percent for real estate transactions between related parties involving $500,000 or less (section 483(g)) would be preserved, as would the exemption for transactions where the sales price does not exceed $3,000. The exception for sales of ordinary income property provided under present law would be eliminated, however.

Possible Alternative Proposal

A possible alternative to the extension of the OID rules to deferred payment transactions involving nontraded property would be to require that both parties to the transaction use the cash method unless they elect to apply the OID rules to a stated value for the property. Thus, discount interest on the obligation would not be taxable to the lender (seller) nor deductible by the purchaser (borrower) until the year in which payment occurred. Earlier accrual would be permitted if both the seller and the purchaser agreed on the purchase price of the property and the yield to maturity of the obligation, and the seller agreed to include annual accruals of interest on the obligation in income according to the stated terms. It would, of course, be necessary to provide a minimum yield to maturity rate for such transactions in order to prevent the fixing of interest at an artificially low rate.

2. Premature Accruals

Present Law and Background

Under the accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy (the so-called "all events test") (Treas. Reg. sec. 1.461-1(a)(2)).[32] If the "all events" test is met, an accrual basis taxpayer generally can deduct the face amount of an accrued expense.[33]

When expenses such as mining reclamation expenses, nuclear power plant decommissioning expenses, workmen's compensation, supplemental unemployment benefits, and plant closing expenses may be deducted has been the subject of controversy under present law.

Strip mining reclamation.—The Surface Mining Control and Reclamation Act of 1977, and similar State laws, impose specific reclamation requirements on surface mine operators. Mine operators must guarantee their compliance with these requirements by posting bonds or otherwise proving their financial responsibility.

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[32] The 1954 Code, as originally enacted, contained a provision allowing accrual method taxpayers to establish reserves to estimated business expenses and to deduct reasonable additions to the reserve (sec. 462). Congress retroactively repealed the provision in 1955 primarily for revenue reasons (Pub. L. 84-74, 69 Stat. 134 (1955)).

[33] To illustrate this point, Treasury presented the following example: Assume that A, an accrual basis taxpayer, incurs in 1983 a legal obligation to pay $100 to B in 1990 for work to be performed in 1990. If A is allowed to deduct $100 in 1983, a gross overstatement of the deduction will occur. As the $100 need not be paid for seven years, A can fund that liability today for much less than $100. Thus, if A set aside $57.23 in 1983, and invested that amount at an 8 percent after-tax rate until 1990, he would in 1990 have exactly the $10 needed to satisfy his liability to B. A's obligation can be described in two ways: (1) an obligation to pay $100 of cash in 1990; or (2) an obligation to pay an amount in the future which in 1983 has a present value of $57.23. From an economic point of view, therefore, A's deduction should be $57.23 in 1983 or $100 in 1990. In no case should A be permitted to deduct $100 in 1983.

Prior to 1978, the courts allowed a surface mining operator to accrue and deduct the estimated expenses of reclamation as mining operations progressed (*i.e.,* State-mandated reclamation expenses accrued as mineral was extracted). *Harrold* v. *Commissioner*, 192 F.2d 1002 (4th Cir. 1951); *Denise Coal Co.* v. *Commissioner*, 271 F.2d 930 (3rd Cir. 1959). In 1978, the Internal Revnue Service issued a private letter ruling which stated that reclamation expenses cannot be accrued until the year in which reclamation occurs. Notwithstanding the Service's 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.

Proposed legislation (H.R. 3342)[34] would provide that a taxpayer may elect to deduct the estimated expense of surface mining reclamation over the life of the mine as minerals are extracted.

In hearings on similar bills introduced in the 97th Congress (S. 1911 and S. 2642) and the 98th Congress (S. 237), the Treasury testified that in their view *Ohio River Collieries* was incorrectly decided and that the "all events test" for accruing deductions does not permit the accrual of estimated reclamation expenses. In addition, the Treasury testified that a current deduction for an expense to be paid in the future fails to take into account the time value of money and, thus, overstates the amount of the current deduction.

Nuclear power plant decommissioning.—Generally, under Federal or State law, requirements to decommission nuclear power plants are imposed on electric utility companies. In some States, the future costs of decommissioning nuclear power plants are included in the cost of service for ratemaking purposes and, thus, are passed through to consumers as increased rates. Amounts received by the utility companies attributable to these increased rates are includible in taxable income by the utility companies. It is unclear under present law when the utility companies may accrue the decommissioning expenses.

Proposed legislation (H.R. 2820)[35] would provide that a deduction would be allowed for an addition to a reserve for the decommissioning costs to be incurred by a regulated public utility in connection with a nuclear power plant.

Workmen's compensation.—Under workmen's compensation acts, employers may be required to pay injured employees' medical expenses and disability benefits. Frequently, when the employee is injured, the employer's liability to provide benefits may extend over several years. It is unclear under present law as to when these expenses accrue.

In *Crescent Wharf and Warehouse Co.* v. *Commissioner*, 518 F.2d 772 (9th Cir. 1975), the Ninth Circuit held that the employer's liability in an uncontested claim under workmen's compensation is fixed when the injury occurs.[36] In 1980, the Internal Revenue Serv-

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[34] Introduced on June 16, 1983, by Messrs. Flippo, Bevill, Shelby, Duncan, Rahall, Erdreich, Edwards (Alabama), Nichols, Murtha, Roe, Mollohan, Brown (Colorado), and Marriott.

[35] Introduced on April 28, 1983, by Messrs. Gibbons, Matsui, Vander Jagt, Schulze, Thomas (California), Fazio, Frenzel, and Conable.

[36] Also see *Wien Consolidated Airlines, Inc.* v. *Commissioner*, 528 F.2d 735 (9th Cir. 1976).

ice ruled that liability is established only upon medical treatment, continuance of disability or continued survival of children.[37] However, in 1983, the Ninth Circuit held that an employer could deduct the estimated amounts payable in future years as workmen's compensation benefits with respect to injuries incurred during the taxable year. *Kaiser Steel Corp.* v. *United States*, 411 F.2d 335 (9th Cir. 1983). The court permitted the question of the "reasonable accuracy" of the amount reserved for anticipated liabilities to be determined by estimating the amount of the liability in aggregate rather than on an individual claim basis. The court accorded no apparent significance to the fact that payment of the workmen's compensation benefits accrued in the taxable year extended over at least 17 years.

Supplemental unemployment benefits.—The courts have held that amounts paid to a trust to fund benefits under a negotiated supplemental unemployment benefit ("SUB") plan may be deducted currently. For example, in *Lukens Steel Co.* v. *Commissioner*, 442 F.2d 1131 (3rd Cir. 1971), the Third Circuit held that, under the accrual method of accounting, the taxpayer was entitled to deduct payments to a trust fund and, in addition, amounts accrued in a "contingent liability account" (at a fixed rate for each hour worked by eligible employees until a target funding amount was reached) on its books. The fact that the liability was to a group, rather than to a specific individual, and that the time of future payment was indefinite, does not bar a deduction under the "all-events" test. Several courts have followed the *Lukens* case in several other cases concerning SUB plan deductions.[38]

The Internal Revenue Service announced in Revenue Ruling 72-34, 1972-1 C.B. 132, that it would not follow the *Lukens* decision on the basis that where there is a contingency as to payment of an obligation (other than the ability of the obligor to pay), the liability cannot be fixed for purposes of the "all-events" test; furthermore, there must be a current liability to pay for an amount to be deductible.

Plant closings.—Frequently a taxpayer must choose between closing or modernizing a plant. It can be argued that tax incentives exist for closing a plant to the extent that the closing permits the current deduction of amounts which need not be paid until far into the future. For example, when a plant is closed, a corporation may become liable to provide lifetime medical and life benefits to retirees.[39] Although these benefits will be paid out over a long period of time, taxpayers may rely on court cases (such as *Lukens Steel*) as authority for an immediate deduction of the estimated future cost

[37] Rev. Rul. 80-191, 1980-2 C.B. 168, in which the Internal Revenue Service announced that it would not follow the Ninth Circuit's decisions in *Crescent* and *Wien*.

[38] Also, see, *e.g.*, *Cyclops, Inc.* v. *United States*, 408 F.Supp. 1287 (W.D. Pa. 1976); *Inland Steel Co.* v. *United* States, 212 Ct. Cl. 558 (1976); *Inland Steel Co.* v. *United States*, Ct. Cl. Trial Div. [80-2 USTC par. 9833] (1980); *Crucible, Inc.* v. *United States*, 591 F.2d 643 (Ct. Cl. 1979); *Timkin Co.* v. *United States*, [78-2 USTC par. 9553] (Ct. Cl. 1978); *Reynolds Metals Co.*, 68 T.C. 943 (1977). *Cf. Zwicker Knitting Mills* v. *United States*, Ct. Cl. Trial Div. [80-2 USTC par. 9832] (1980) (deduction allowed for accrual under negotiated employee welfare plan); *Rath Packing Co.* v. *Bacon*, 255 F.Supp. 809 (S.D. Iowa 1966) (same with respect to negotiated automation study plan).

[39] The treatment of employee benefit costs in connection with a plant closing depends on the type of benefit. Generally, pension benefits are deductible when paid into a qualified trust fund (sec. 404(a)).

of the benefits. Thus, by closing a plant, deductions for estimated future costs of benefits could result in a net operating loss which could be carried back to prior years, resulting in an immediate refund of taxes. To the extent that the refund is worth more than the present value of the deductions attributable to the deduction of the future liability for employee benefits, it may be more advantageous for the taxpayer to close the plant rather than to modernize and continue operating the plant.

Administration Proposal

The Administration proposal would provide that, in determining whether an amount has been incurred with respect to any item during the taxable year, all the events which establish liability for such amount would not be treated as having occurred any earlier than the time economic performance occurs.

The time at which economic performance occurs would generally mean when services are performed, property provided, use of property occurs and, in the case of workmen's compensation or similar liability, when the liability is satisfied. Economic performance would occur in the strip mining cases, for example, when the land is reclaimed; in the nuclear power plant decommissioning cases when the nuclear power plant is decommissioned; and in the workmen's compensation cases when payments are made to claimants.

Exceptions would be provided for items to which other sections of the Code apply; for example, the deductions allowable for additions to a reserve for bad debts (sec. 166), accrual of vacation pay (sec. 463), qualified discount coupons (sec. 466), and any other provision which specifically provides for a reserve for estimated expenses.

Under the proposal, the net operating loss carryback rules would be amended to provide a 10-year carryback period for certain deferred liability losses. A special rule would be provided for nuclear power facilities; net operating losses could be carried back to the year in which liability for decommissioning the nuclear power facility arose. Transition rules would limit the years to which losses could be carried back under these amended carryback rules.

3. Prepayments of Expenses

Present Law and Background

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 (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, does clearly reflect 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. Ss 1.461-1(a)(1) and (2)).[40]

Deductions for interest.—Under the cash receipts and disbursement method of accounting, deductions generally are allowed in the year in which the expenditures are paid. Under present law, if a taxpayer uses the cash receipts and disbursement 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 prepaid interest only in the period in which the use of money occurs. Thus, prepaid interest is deductible in the same period for both cash and accrual method taxpayers.

Deductions other than interest.—Present law is unclear as to the proper timing of a deduction for prepaid expenses, other than interest. No specific statutory provision expressly permits expenses to be deducted in full when paid by a taxpayer using the cash receipts and disbursements method of accounting.[41]

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.[42] Under this rule, prepayments generally may be deducted if they do not provide benefits that extend beyond one year. Thus, a calendar-year cash-basis taxpayer could deduct a one-year lease payment paid in December.

Special rule for farm syndicates.—Present 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

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[40] Capital expenditures are generally defined as those which create assets having a useful life substantially beyond the taxable year (Treas. Reg. Ss 1.263(a)-2(a)).

[41] The Internal Revenue Service has provided some guidance regarding the factors to be considered in determining whether there is a material distortion of income. See, *e.g.*, Rev. Rul. 79-229, 1979-2 C.B. 210, which lists several factors which may be considered in determining whether there is a material distortion of income in the case of advance payments for livestock feed: the useful life of resulting assets during and beyond the tax year paid; relationship of the amount of the prepaid expenditure in question to the projected magnitude of the business in a subsequent year; the purpose for paying in advance; whether the taxes paid by a taxpayer consistently deducting prepaid feed costs over a period of years are reasonably comparable to the taxes that would have been paid had the same taxpayer consistently not paid in advance; the customary business practice of the taxpayer in conducting his livestock operations; the amount in relation to past purchases; the time of the year made; and the materiality in relation to the income for the year of payment.

[42] *Zaninovich* was recently cited with approval as authority for deducting prepaid rent by the Supreme Court in *Hillsboro National Bank* v. *Commissioner*, 457 U.S. 1103 (1983). Although the *Hillsboro* case turned on the application of the tax benefit rule, in reaching its decision, the Supreme Court determined that a rental paid 30 days in advance was properly deducted under *Zaninovich*. The one-year rule has been applied by several circuits in distinguishing between currently deductible expenses and capital expenditures having a useful life extending "substantially beyond" the taxable year.

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 actually participate in the management of the enterprise).

Timing of the recognition of income.—As a general rule, both cash and accrual method taxpayers are required to include prepayments or advance payments in income in the year of receipt without regard to whether the payor is granted a deduction. *Automobile Club of Michigan* v. *United States*, 367 U.S. 687 (1961); *Schlude* v. *Commissioner*, 372 U.S. 128 (1963). There are a number of exceptions to this general rule, however. For example, first, recognition of that portion of a prepayment received for services to be performed during the succeeding taxable year after the year of receipt may be deferred. This rule applies only if no part of the services is to be performed at an unspecified date which may occur after the end of such succeeding taxable year (Rev. Proc. 71-21, 1971 C.B. 549). Second, advance payments received with respect to certain long-term contracts do not have to be included in the taxpayer's income until the year the contracts are complete. Third, advance payments for inventory sales may be included in income by accrual-method taxpayers upon receipt or as properly accrued under the seller's method of accounting, provided that they are accrued no later than accrued for financial and other purposes. Generally, deferral of the income recognition is limited to two taxable years following the year of prepayment.

Many tax shelters rely on the deductibility of year-end payments for expenses allocable to future time periods. Thus, cash-basis taxpayers may shelter other income by prepaying expenses (other than interest). Taxpayers may benefit significantly, for example, by accelerating deductions into a high-income year when lower income is anticipated in future years. The benefits can be significant even when the deduction is accelerated only for one year.

Administration Proposal

Under the Administration proposal, a tax shelter would not be allowed a deduction with respect to any amount earlier than the time at which such amount is treated as incurred. An amount would not be treated as incurred at any time earlier than the time at which economic performance occurs. Thus, a cash basis tax shelter could not deduct an amount until economic performance occurs and the amount is paid.

A tax shelter would mean (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).

4. Deferred Like Kind Exchanges

Present Law and Background

Under present law, no gain or loss generally is recognized on the exchange of like kind property (sec. 1031). In *Starker v. U.S.*, 602 F.2d 1341 (9th Cir. 1979), the United States Court of Appeals for the Ninth Circuit held that an exchange qualified as a like kind exchange although the exchanged property could be designated by the transferor for up to 5 years after the transaction was opened and although the exchange might ultimately fail to qualify for like kind treatment in the event the transferor received non-like kind property.

Administration Proposal

Any property received by the taxpayer more than 90 days after the taxpayer transfers the property relinguished in the exchange would be treated as property which is not like-kind property.

5. LIFO Conformity

Present Law and Background

The "Last-In-First Out" (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. This rule is intended to prevent businesses from taking inconsistent positions for tax and book purposes as to the method of inventory accounting (e.g., the LIFO method, which tends to minimize income in an inflationary environment, for tax purposes, and the "FIFO" (First-In-First-Out) method, which tends to maximize income in such an environment, for financial accounting purposes).

An issue has arisen as to whether a parent company is subject to the LIFO conformity rules when the inventory is held by a subsidiary company. In *Insilco Corp. v. Commissioner*, 73 T.C. 589 (1980), the Tax Court held that as long as a subsidiary on the LIFO method computes its income in its financial reports issued to its parent company, the conformity requirement would be met. Thus, the parent company was permitted to convert a subsidiary's earnings reported to its parent computed using the LIFO method to a non-LIFO basis in the parent's consolidated financial statements. (The Tax Court's decision was affirmed in an unreported decision by the Second Circuit.)

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, 78-1 C.B. 146, the Internal Revenue Service ruled that foreign parent corporations are permitted to convert the operating results of their subsidiaries using the LIFO method to a non-LIFO basis in consolidated financial statements under certain conditions.

Administration Proposal

Under the Administration proposal, the LIFO conformity requirement would be applied to a controlled group of corporations. Thus, the conformity rules could no longer be avoided through the creation of subsidiaries or holding companies. The proposal would not affect the limited exceptions to the conformity rule provided under present law (for example, for parent companies located in countries where the use of LIFO is not permitted).

6. Low-Interest and Interest-Free Loans

Present Law

Low-interest and interest-free loans are currently being used to avoid long-standing tax rules that require shareholders to include dividends in income, disallow assignments of income to family members through short-term trusts, and prohibit deductions of interest for certain tax-free or tax-sheltered investments. The proper tax treatment of such loans has been the subject of extensive litigation without a comprehensive resolution of the issues.

Administration Proposal

Low-interest and interest-free loans would be recharacterized as two arms-length transactions. Under this approach, the parties to a low-interest or interest-free loan would be treated as if:

(1) The lender made a loan to the debtor in exchange for a note requiring the payment of interest at a safe harbor rate;

(2) The lender (A) made a gift subject to a gift tax (in the case of a transaction between family members), or (B) paid a dividend includible in income (in the case of a transaction between a corporation and a shareholder) or compensation includible in income (in the case of a transaction between an employer and an employee or independent contractor) to fund the payment by the debtor of the interest on the loan; and

(3) The debtor paid interest on the loan at a safe harbor rate resulting in income to the lender and a deduction to the debtor.

Appropriate *de minimis* exceptions would be provided. In the case of a loan between family members, these exceptions would provide that low-interest and interest-free loans of less than $100,000 in the aggregate to a family member generally would be free of tax consequences unless the debtor has more than a *de minimis* amount of passive investment income. In a services-related context, a $10,000 cumulative *de minimis* amount would be provided. In addition, low interest insurance policy loans, bank deposits and other similar non-tax motivated commercial arrangements, loans made by sellers of property in a transaction governed by section 483, and loans bearing at least a specified minimum interest rate would not be affected by the proposal.

7. Inclusion of Tax Benefit Items in Income

Present Law and Background

Under present law, a taxpayer who recovers an item for which a deduction was claimed in a prior tax year must recognize income if the deduction resulted in a reduction in taxes in the earlier year. Under the judicially created tax benefit rule, the taxpayer takes into income an amount equal to the portion of the deduction that produced a tax benefit. This principle has been codified (in sec. 111) as to recoveries of bad debts and taxes previously deducted.

Although section 111 refers only to a "recovery" of previously deducted items, the Supreme Court in a recent decision held that an actual recovery of value is not a prerequisite to invocation of the tax benefit rule. The rule may be invoked whenever an event occurs subsequent to a deduction which is fundamentally inconsistent with the premise on which the deduction was initially based (*United States* v. *Bliss Dairy, Inc.*, 104 S. Ct. 1134 (1983)). The court held that the determination of whether a fundamentally inconsistent event has occurred and, if so, whether a particular nonrecognition provision of the Code overrides the tax benefit rule, must be made on a case-by-case basis.

Issues

Section 111, as amplified by regulations, has the effect of allowing an individual taxpayer to recover tax-free State taxes and other items deducted as itemized deductions in a prior year up to the amount by which the zero bracket amount exceeds the taxpayer's other itemized deductions for that year. A similar problem may arise with respect to other items subject to a statutory "floor." The taxpayer is treated as having first recovered the portion of the deduction that did not reduce taxable income in the prior year. Such treatment (which is attributable to an arbitrary assumption about the order in which the previously deducted dollars are recovered) arguably does not reflect economic reality. The first dollars recovered by the taxpayer in this situation are in fact those which produced the reduction in taxable income in the earlier year.

Despite the Supreme Court's attempt to clarify the tax benefit rule, much confusion continues to surround the rule's application in situations where there has been no literal recovery of value or cancellation of liability. The Supreme Court's formulation of the tax benefit rule is difficult to apply and fails to provide either taxpayers or the government with sufficient certainty of outcome. For example, under this ruling the rule may apply in situations where a business expense deduction is claimed with respect to property which is later converted to personal use. Whether and to what extent the rule governs other situations, particularly those where a nonrecognition provision of the Code applies, is, however, unclear.

Possible Proposals

The order-of-recovery problem of section 111 could be resolved by amending the statute to provide that, if State taxes, medical expenses, or other items previously claimed as deductions are refunded to or recovered by a taxpayer, the portion (if any) of the deduction for those items that produced a tax benefit will be presumed to have been recovered first; this amount would be taken into income in the year of the recovery.

In addition, in view of the uncertain scope and application of the tax benefit rule under present law, consideration may be given to making clarifying amendments to section 111. It may be appropriate to embody in these amendments a broad notion of income recapture. The statute could be amended to make it clear that the tax benefit rule may apply even if there has been no actual recovery or cancellation of a liability, so long as there has been a constructive recovery.

Constructive recovery could be defined generally in the statute and amplified by regulations. Although it would be impractical to specify all instances in which the rule would apply, it might be appropriate to describe on a nonexclusive basis certain situations (those identified as arising frequently or as being most subject to abuse) in which a recovery will be deemed to have occurred. For example, the statement in *Bliss Dairy* as to the tax consequences of a conversion of business property to personal use might be embodied in the statute (compliance problems posed by such a rule would, however, have to be considered).

The revision of section 111 might involve clarification of the application of the tax benefit rule to dispositions of assets in the course of complete liquidations and to other transactions under nonrecognition provisions of the Code. This might also provide an opportunity to consider the relationship of recapture rules to the incentives to churn ownership of assets, and to consolidate, simplify, and (where appropriate) strengthen recapture rules contained in various sections of the Code (e.g., secs. 1245, 1250, and 617).

8. Income Averaging

Present Law

Under present law, if an eligible individual has averageable income, i.e., an excess of current year taxable income over 120 percent of average taxable income in the previous 4 years, then he may be eligible for income averaging.

Under income averaging, a taxpayer may average income from a high income year over the preceding 4 years.[43] This procedure thus serves 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 apply if 100 percent of averageable income were taxed using the regular rate schedule.

Background

In recent years, the percentage of taxpayers using income averaging has increased substantially. Taxpayers whose income has increased merely at the rate of inflation may be eligible for income averaging, under the current provision. Thus, it can be argued that the design of this provision should be changed to limit its benefits to those for whom it was originally intended—taxpayers with a

[43] To use this method, the individual first computes "averageable income," which generally is the excess of the current year's taxable income over 120 percent of average taxable income in the previous 4 years ("average base period income"); individuals may not use the income averaging formula unless averageable income exceeds $3,000. Next, the individual calculates what tax liability would be on 120 percent of average base period income. Then the individual computes the increase in tax liability which would result if 20 percent of averageable income were added to 120 percent of average base period income. This increase is then multiplied by 5 and added to the tax liability calculated above on 120 percent of base period income in order to determine the individual's tax liability for the year. (These tax liability computations are performed using the current year's rate schedules.)

sharp jump in real income. This argument is especially compelling when tax brackets are indexed, since indexing by itself keeps marginal tax rates constant for an individual whose increases in income are entirely attributable to inflation.

Possible Proposals

The 120-percent threshold could be raised to 140 percent. In addition, the base period could be shortened to be the three most recent prior years.

9. Tax Treatment of Premature Employer Contributions to Benefit Plans

Present Law and Background

Summary of present law

Under present law, the tax treatment of employees is generally more favorable if compensation is provided in the form of employee benefits than in the form of wages.[44] In some cases, the tax treatment of an employer may also be more favorable if compensation is provided in the form of employee benefits.

Under an employee benefit plan, an employer may be allowed a deduction for a contribution before the benefit is available to the employee. In addition, the contribution may be made to a tax-exempt organization so that no tax will be imposed on investment earnings during the period between the time the employer's contribution is made and the time the organization makes a payment for the benefit. In this respect, the treatment of benefits differs from the treatment of wages. The year in which wage payments are deductible generally is matched with the year in which the payments are includible in the employee's income, and no tax-exempt entity is authorized to hold funds to be used to disburse wages.

Present law attempts to distinguish between benefits provided as deferred compensation and those provided as welfare benefits. Advance deductions and tax-exempt trusts are available for deferred compensation only if the plan satisfies specific requirements (a "qualified pension plan"). Accordingly, if a deferred compensation plan does not satisfy these requirements, the benefit of tax deferral provided to an employee because the compensation earned currently is not currently included in gross income is balanced, to some extent, by the deferral of the employer's deduction for providing the deferred compensation. In particular cases, the effect of the deferral of the income and deduction can reduce the aggregate tax imposed on the employee and employer because of changes in the applicable tax rates.

The Code provides for three types of employee benefit plans:

Qualified pension plans.—If a plan is a qualified pension plan, then (1) employers are generally allowed deductions (within limits) for plan contributions when paid even though the contributions are

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[44] Certain benefits are excluded from an employee's gross income. These include all contributions to, and benefits paid under, health and certain disability plans, and, if certain conditions are satisfied, up to $50,000 of group-term life insurance, all payments under vanpooling, group legal services, and dependent care assistance plans.

not included in the gross income of employees until benefits are distributed under the plan, and (2) a trust under the plan is generally exempt from income tax, so earnings on assets held to provide benefits are not taxed.

Pension plans qualify for this favorable tax treatment only if they meet standards provided by the Code. In particular, these plans must not discriminate in favor of employees who are officers, shareholders, or highly compensated. Also, a qualified plan must meet minimum standards regarding benefit accruals, employee participation, and limiting delays in vesting. In addition, the Code provides limits on contributions or benefits under qualified plans. These limits do not apply to medical benefits paid from a qualified plan.

Welfare benefit plans.—If benefits under a plan are considered welfare benefits rather than deferred compensation, the tax treatment of the employer is similar to that provided for qualified plans. That is, the employer is generally allowed a current deduction for plan contributions even though the benefits may not be provided to employees until a future period. In addition, the contributions to provide certain welfare benefits may be held by a tax-exempt organization. An organization may be tax exempt under the rules relating to VEBAs, supplemental unemployment benefit trusts, or social clubs. Also, earnings on assets held in an account of a life insurance company to provide certain life insurance benefits may be exempt from income tax.

The rules for welfare benefit plans do not include minimum standards for vesting or the rate of benefit accrual. If a VEBA is used as the funding medium, however,a modified antidiscrimination rule is provided (the rule is not as stringent as the antidiscrimination standard applicable to qualified pension plans).

Benefits in the form of vacation facilities, health and disability insurance, severance and layoff pay, recreational facilities, and life insurance may generally be provided under a welfare plan. The Code, however, does not provide a clear distinction between welfare benefits and deferred compensation. For example, in the past, a plan providing deferred educational benefits to the children of an employee was considered to be a plan of deferred compensation but, under a recent case, may be structured as a welfare benefit plan.

If an expense is paid in advance, however, the full amount of the expense may not be deductible in the year of the payment under the usual accounting rules of the Code. For cash or 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.[45] The regulations provide for rat-

[45] Treas. Reg. sec. 1.461-1(a)(1). A taxpayer electing an accrual method of accounting may make an election under section 463 to deduct an amount representing a reasonable addition to a reserve account for both vested and contingent vacation pay earned by employees in the current year and payable by the close of that year or within 12 months thereafter. A deduction is allowed in the current year regardless of when the amount is actually paid, so long as the employees have a right to receive the payments during that year or the following year.

able amortization of such items. For example, if a cash method taxpayer prepays premiums on insurance provided as an employee benefit, proration of the premiums has generally been required to determine the amount deductible in a particular year.[46] Courts have permitted exceptions where there is only a de minimis difference between the amount allowed as a deduction on the basis of current payments and the amount allowed if the premium is amortized.[47] Proration has also been required in the case of life insurance premiums paid by an accrual method taxpayer.[48] In the case of a welfare plan providing life insurance benefits to certain active and retired employees of a corporation, a deduction is allowed for a contribution to the extent that the contribution is determined actuarially and is made on a level basis. [49] Private rulings have extended the principle of actuarial computation and level funding to other benefits.

Nonqualified deferred compensation plans.—Under a nonqualified deferred compensation plan, the employer's deduction for a plan contribution is not allowed until an amount attributable to the contribution is includible in the employee's gross income. Similar rules apply to deferred compensation arrangements with independent contractors.

No tax exemption is provided for an organization that serves as the funding medium for a deferred compensation plan. Accordingly, if the employer owns assets that are intended to be used to provide the deferred compensation, the earnings on those assets are includible in the gross income of the employer under the usual rules of the Code. Deferred annuity contracts, under which investment earnings are not taxed to the owner of the contract until benefits are paid, are often purchased by employers to meet their obligations under deferred compensation plans.

The Employee Retirement Income Security Act of 1974 (ERISA) generally precludes the use of unfunded deferred compensation plans as a means of providing retirement benefits to rank-and-file employees. The more favorable treatment of qualified plans is designed to provide an incentive for employers to establish qualified plans instead of deferred compensation plans.

Tax implications of different benefit arrangements

The treatment of compensation as wages, employee benefits, a qualified pension or nonqualified deferred compensation has a substantial effect on the after-tax cost to the employer of providing these different types of compensation. This section illustrates these effects through the use of examples of prefunded compensation payments.

Suppose a corporation in the 46-percent tax bracket wishes to set aside $1,000 at the beginning of each year for 20 years in order to

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[46] Rev. Rul. 70-413, 1970-2 C.B. 103.

[47] *Waldheim Realty and Investment Co.* v. *Commissioner* 245 F.2d 823 (1957) and *U.S.* v *W.M. Morton, Sr.* 387 F.2d 441 (1968). In one case, however, deductions were allowed for current payments attributable to more than one year where this was a long-standing practice of the taxpayer (*First Federal Savings and Loan Association of St. Joseph* v. *U.S.* 288 F. Supp. 477 (1968)).

[48] *Trinity Construction Co., Inc.* v. *U.S.* 424 F.2d 303 (1957).

[49] See, for example, Rev. Rul. 73-599, 1973-2 CB 40 (modified by Rev. Rul 77-92, 1977-1 CB 41. The ruling applies to a welfare plan providing life insurance benefits for certain of the active and retired employees of a corporation.

fund a compensation payment which it expects to make at the end of the 20th year. The $1,000 figure is the after-tax cost it is willing to bear, so that if the payment is deductible, the employer would be willing to contribute $1,852 per year.

Table 3 shows the accumulation that would be available to provide benefits under four different methods of designing the compensation plan. Column (1) shows the results if the employer simply places nondeductible contributions of $1,000 per year in a separate bank account earning 15 percent interest. Interest on this account is assumed to be taxable. After 20 years the contributions and accumulated interest, minus annual taxes on the interest, total $50,020. The employer then may make a compensation payment of $92,630, financed by the $42,610 deduction available for this payment (.46 x $92,630) and the balance in the account. If the employer's tax bracket in the final year were lower, perhaps because of the retirement of principal employees, the benefit of the deduction, and thus, the total payment, also would be reduced.

The remaining columns show that for the same after-tax cost, the employer will be able to pay the employee a considerably greater amount if the contributions are placed into an employee benefit plan than if they are accumulated in a taxable bank account. Column (2) shows the results of making annual, deductible contributions of $1,852 (with an after-tax cost of $1,000) to a qualified pension plan, the income of which is tax free. Given the interest rate and length of time chosen for this example, a payment of $218,185 may be made to the employee at the end of the 20-year period—2.4 times larger than the $92,630 which would be paid if a taxable bank account were used. The difference would be even larger if the employer's tax bracket were below 46 percent in the final year.

Column (3) shows the results of using a deferred compensation plan which does not meet the participation, vesting, benefit accrual, nondiscrimination, or other standards necessary for qualified status. Under this arrangement, a nondeductible contribution of $1,000 is assumed to be placed in a deferred annuity, the income of which is tax-free during the accumulation period. Thus, the only difference between column (2) and (3) is in the timing of the deduction. By the end of year 20, the annuity balance is $117,810. The employer is allowed a $20,000 deduction when the funds are paid out. Thus, the employer can make a $134,847 payment to the employee, financed by the annuity balance, the $9,200 benefit of the deduction for the annuity contributions, and the $7,837 benefit of the deduction for excess of the payment over the annuity value. This result, although more favorable than the taxable account in column (1), is considerably less favorable than the outcome under a qualified plan. The difference in tax treatment clearly provides a substantial incentive to satisfy the requirements of qualified plans. The difference would be even larger if the employer's tax bracket were lower in the final year than during the period when the contributions were made.

The last column shows the results if an annual, deductible contribution of $1,852 is made to a severance pay plan, funded using a tax-exempt VEBA. The results are identical to those obtained using a qualified pension plan, because the tax treatment of the employer contributions to the two types of arrangements is basically the same.[50] An employer may establish both a severance pay plan and a qualified plan, and fewer conditions must be satisfied for the former than the latter. It should be noted that there is a large difference between the treatment of a plan considered to be nonqualified deferred compensation (col. (3)) and a welfare benefit plan not considered to be deferred compensation (col. (4)). Under present law, as discussed below, the dividing line between these two types of arrangements is subject to considerable uncertainty.

[50] Some concern has been expressed that this tax treatment places insurance companies at a competitive disadvantage, because investment income on their reserves is not generally exempt from tax.

Table 3.— Balance in Various Compensation Accounts at End of Year, Assuming $1,000 Annual After-tax Contribution

	Taxable bank account	Qualified pension plan	Nonqualified deferred compensation plan, funded with annuity	Severance pay plan funded with tax-exempt trust
Year:				
1	$1,069	$2,130	$1,150	$2,130
2	2,250	4,579	2,473	4,579
3	3,513	7,396	3,993	7,396
4	4,878	10,635	5,742	10,635
5	6,354	14,360	7,754	14,360
6	7,950	18,644	10,067	18,644
7	9,675	23,570	12,727	23,570
8	11,540	29,235	15,786	29,235
9	13,556	35,750	19,304	35,750
10	15,735	43,243	23,349	43,243
11	18,090	51,859	28,002	51,859
12	20,636	61,768	33,352	61,768
13	23,389	73,163	39,505	73,163
14	26,364	86,267	46,580	86,267
15	29,581	101,337	54,717	101,337
16	33,058	118,667	64,075	118,667
17	36,817	138,597	74,836	138,596
18	40,880	161,516	87,212	161,516
19	45,272	187,873	101,444	187,873
20	50,020	218,184	117,810	218,184
Payment to employee	92,630	218,184	134,847	218,184

Assumptions: (1) Employer is a corporation in 46-percent tax bracket in all years, and (2) the annual interest rate is 15 percent.

Background and history of VEBAs

In 1926, the Board of Tax Appeals held that a voluntary relief fund organized to pay benefits to members in case of sickness or accident, or to provide health benefits, was a taxable entity, absent a specific statutory exemption.[51] The organization was funded solely by dues collected from its members. In 1928, a statutory tax exemption for voluntary employees' beneficiary associations (VEBAs) was provided if (1) no part of the association's net earnings inured to the benefit of any private individual or shareholder other than through the payment of permissible benefits and (2) at least 85 percent of the association's income was collected from members to pay benefits or administrative expenses.

A subsequent B.T.A. decision led to a provision of the Revenue Act of 1942 that permitted employer contributions to be treated as member contributions for purposes of the 85 percent test.[52] Thus, employers were permitted, as of 1943, to contribute to a tax-exempt association designed to provide life, sick, accident, or other benefits to their employees.

The primary income tax advantages of these VEBAs (also referred to as section 501(c)(9) trusts) did not become a significant motivating factor for employers until 1969. Prior to that time, the 15 percent limitation on investment income prevented a VEBA from accumulating sizeable reserves. The Tax Reform Act of 1969 eliminated the 85 percent test and subjected VEBAs to the unrelated business taxable income rules. Under a VEBA, dues and investment income are subject to unrelated business income tax unless "set aside" to provide permissible benefits. Thus, the rules provided by the 1969 Act set no limits, other than the rules relating to unrelated business income, on the amount of reserves a VEBA could accumulate or the amount of benefits the VEBA could pay.

Recent developments in use of benefit arrangements

In the last few years and, especially in 1983, there has been a substantial acceleration of the growth in the number of VEBAs in existence. According to the Internal Revenue Service, the number of active section 501(c)(9) organizations to which favorable determinations were issued had increased from 7,791 on November 30, 1980 to 8,753 on June 30, 1983, an annual growth rate of approximately 5 percent. By September 30, 1983, the number of VEBAs was 8,934, an annual growth rate of approximately 9 percent. By January, 1984, there were more than 9,400 VEBAs in existence; this represents an annual growth rate of 21 percent. New applications continued to accelerate as well. Between June 30, and September 30, 1983, more than 450 applications for new VEBAs were received by the IRS.

A factor that may have caused the recent increase in VEBA activity was the enactment of the pension provisions of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). Congress

[51] *Philadelphia & Reading Relief Association v. Commissioner*, 4 B.T.A. 713 (1926).

[52] See, *Shell Employees' Benefit Fund v. Commissioner*, 44 B.T.A. 452 (1941). The Senate Finance Committee Report stated "Present law has worked a hardship in the case of some beneficiary associations where the employer is willing by contribution to increase the amount available for making such payments and for meeting expenses of the association."

had become concerned that qualified pension plans were being used to provide excessive tax benefits to relatively high income individuals. Rules were adopted which lowered the dollar limits on the annual contributions that could be made to a qualified plan and the benefits which could be provided. In addition, further restrictions on certain plans required increased benefits for rank-and-file employees.

Shortly after the enactment of TEFRA, a large number of articles in professional journals pointed out that the tax benefits of a welfare benefit plan linked to a VEBA were very similar to those available under a qualified pension plan and that considerably fewer restrictions applied to VEBAs. In one such article, an example is given of how a small professional corporation may utilize the tax benefits of a severance pay plan provided under a VEBA. In this example, the employees of the corporation are two doctors ages 50 and 55, with annual salaries of $150,000 and $200,000, respectively, and three other workers, ages 20 to 35, with annual salaries of $10,000 to $18,000. The example indicates that the corporation could make tax deductible annual contributions to a tax-exempt VEBA of more than $55,000 annually under terms which would make it unlikely that the three lower paid employees would receive substantial benefits from the plan.[53] Some of this literature also pointed out that a VEBA could be used to acquire ski chalets and yachts for the use of the employees. Data are not yet available which would show whether average reserves of VEBAs established since the enactment of TEFRA, as a percentage of benefits paid out, are higher than those for VEBAs that previously had been in existence. For VEBAs in existence in 1980, assets held at the end of that year were approximately 40 percent of benefits paid during the year.

Another factor that may have contributed to the recent upsurge in interest in VEBAs has been the evolution in judicial interpretation of whether a benefit plan is a deferred compensation plan. As discussed above, current deductions are not allowed for contributions to a nonqualified deferred compensation plan, and VEBAs may not be used in connection with such a plan. The decision in *Greensboro Pathology* dealt directly with this issue and received considerable attention among tax practitioners.[54] In that case, the employer was a corporation consisting of four physicians who were both shareholders and employees, one physician who was not a shareholder, and a secretary. The corporation established an educational benefit plan for the children of the employees to provide an annual benefit of up to $4,000 of expenses for up to four years of undergraduate or graduate education. At the time the plan was established, only the physician-shareholders had children, and the oldest child was in grade 7. A trust under the control of an independent trustee was established to fund the plan, the trust pro-

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[53] *See*, "VEBA is the Planner's Response to TEFRA Limitations," William G. Hammond and Daniel T. Compton, *The Financial Planner*, Sept. 1983. Also, see "Self-funded VEBAs offer many of the advantages that defined-benefit plans did before TEFRA," Carol W. Wilson, *Estate Planning Journal*, Nov. 1983; "VEBAs and Universal Life," H. Wayne Harrell, *Life Insurance Selling*, May 1983; "How to Provide Low-Cost Vacation Benefits Through VEBA," Christopher Frey, *Financial Planner*, August 1983; and "Is This the Answer to Your Fringe-Benefits Problem?," Sheldon H. Gorlick, *Medical Economics*, Aug. 1983.

[54] *Greensboro Pathology Associates, P.A.* v. *U.S.*, 698 F.2d 1196, Fed.Cir. (1982).

vided that the plan assets could not revert to either the corporation or its shareholders, and the plan stipulated that a child's eligibility for benefits would cease upon the parent's termination of employment with the corporation for any reason other than death, disability, or normal retirement. The taxpayer claimed a current deduction for plan contributions, on the basis that the plan was a welfare benefit plan, not a deferred compensation plan. The Internal Revenue Service contested this position, and the court ruled in favor of the taxpayer. This decision generally is viewed as increasing the scope of plans for which a current deduction for deferred benedits is allowed.

Issues

The present status of the tax treatment of employee benefit plans raises several possible areas for committee consideration.

First, the Committee may wish to consider to what extent favorable tax treatment of employer contributions to welfare benefit plans, relative to payments for wages and salaries, is appropriate in view of the favorable tax treatment also provided when the employees receive the benefits. Payments of medical, certain disability, certain life insurance, legal services, dependent care assistance, and other benefits are excluded from the employee's gross income, in contrast to the treatment of wages and salaries.

Second, the Committee may wish to consider to what extent the availability of favorable tax treatment for contributions to welfare benefit plans reduces the incentives for employers to maintain qualified pension plans, which must satisfy far more restrictions to obtain similar tax treatment. The favorable treatment of the latter is often viewed as an incentive for employers to satisfy the various conditions, intended to protect plan beneficiaries, which are required for plan qualification. Under present law, the availability in a welfare benefit plan of similar tax treatment, with fewer employee protections, may undermine this incentive.

Third, the Committee may wish separately to consider the two basic elements of the favorable tax treatment for contributions to welfare benefit plans. It may wish to consider rules which would allow deductions for these contributions only at the time the benefit is paid rather than at the time the contribution is made, and it may wish to consider restricting the use of tax-exempt entities to plans that (1) satisfy nondiscrimination requirements and (2) do not pay benefits which are essentially equivalent to wages or to deferred compensation.

Possible Proposals

Amount and timing of deductions

Under the proposal, the rules for determining the amount and timing of employer deductions for contributions paid under a funded welfare benefit plan generally would be conformed to the rules for determining the amount and timing of employer deductions for contributions paid under nonqualified plans of deferred compensation.[55]

Under the proposal, the deduction for a contribution to funded welfare benefit plans would be limited to sum of (1) the portion of the contribution that is includible in the gross income of employees during the year (or would be includible but for an exclusion provided by the Code), (2) contributions made in prior years, for which a deduction has not previously been allowed, that are (or would be) includible in the gross income of employees during the taxable year, and (3) the amount necessary to increase a reserve under the plans to the permitted level.

Under the proposal, benefits and administrative expenses would first be considered to be paid from the reserve. Amounts paid from the reserve would not be taken into account in determining the employer's deduction for benefits or expenses.

Generally, the reserve under the plan could not exceed 50 percent of the average annual benefits paid under the plan during the preceeding 3 years. A higher percentage could be permitted under Treasury regulations in appropriate cases. For example, a higher percentage would be allowed in the case of a collectively bargained plan under which employer contributions are curtailed in the case of a strike or layoff. Also, a higher reserve could be maintained if necessary to provide for claims incurred but not paid. Treasury regulations could provide that the opinion of an enrolled actuary would be required to justify a larger reserve.

For purposes of determining the timing of the employee's deduction, the year of employees' includibility would be determined under the rules for nonqualified plans of deferred compensation. Under those rules, the benefit is includible in the gross income of an employee when the employee's interest in the benefit is substantially vested or, if later, when actually or constructively received. Expenditures for depreciable assets would be considered to provide employee benefits in a year in an amount equal to the deduction for that type of asset generally allowable in that year (e.g., under sec. 168 for recovery property).

These rules generally would not apply to deductions for deferred compensation plans, except that for purposes of determining the maximum employer deduction for contributions to a qualified pension plan, the employer would not be permitted to take into account projected retirement benefits, including post-retirement medical benefits, in excess of the dollar limits applicable to defined benefit plans.

Treatment of certain exempt organizations

Welfare benefit plans would be required to meet certain conditions in order for a trust forming part of such a plan to be entitled to tax-exempt status.

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[55] The deduction would be allowed only if it meets the requirements of sec. 162. Other restrictions that would be applicable if the amounts had been paid directly, such as the rules of secs. 168, 263, 264, and 274 would also apply to deductions for plan contributions, depending on the use of those contributions. A conforming amendment to section 463 would be made to allow accrual only of the amount of vacation pay the employer reasonably expects actually to pay before the end of the following taxable year.

Severance pay and supplemental unemployment benefit plans

Under the proposal, benefits paid by reason of separation from service, including layoffs, could be provided by a tax-exempt trust described in section 501(c)(9) or (17) only to the extent that these benefits, when added to benefits provided to employees under a qualified pension plan, do not exceed the dollar limits on benefits applicable to qualified pension plans.[56] In applying these limits, the rules aggregating employees of related employers would apply. The proposal would not treat life, sick, accident, or disability benefits that are continuations of benefits paid prior to separation from service as benefits paid by reason of separation from service.

Voluntary employees' beneficiary associations

Under the proposal, the present-law nondiscrimination rules applicable to VEBAs would be clarified. These rules would apply with respect to eligibility to participate, availability and utilization of benefits, and distribution of benefits upon termination of the association. Thus, under the proposal, not more than 25 percent of the benefits provided annually under a VEBA could be provided to members who are officers, owners, or highly compensated employees. In addition, in testing for nondiscrimination, the rules aggregating employees of related employers would apply.

Any benefit provided by a VEBA that ceases to be tax-exempt would be considered to be wages or salary and thus includible in the gross income of a highly compensated employee to the extent the benefit does not consist of contributions made by the employee and previously has not been included in gross income. Under the proposal, this rule would apply even though the benefit otherwise qualifies for exclusion from gross income.

The proposal would provide that a VEBA may not pay benefits that are essentially equivalent to wages. For purposes of this rule, any benefit that is provided in a manner that violates the nondiscrimination standards established in the Code for the exclusion of the benefit from an employee's gross income would be treated as a benefit essentially equivalent to wages. In addition, benefits could be treated as essentially equivalent to wages if the payment of a benefit is contingent only upon the performance of additional services for the employer. An example of such a benefit could be vacation pay. Benefits payable upon an event unrelated to the performance of services, such as life, sickness, accident, use of a facility, or disaster, would not be treated as equivalent to wages.

Social or recreational clubs and supplemental unemployment benefit trusts

Under the proposal, supplemental unemployment benefit trusts and recreational facilities provided by a social club for employees and funded by employer contributions would be subject to nondiscrimination rules similar to the rules applicable to VEBAs.

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[56] Section 415.

(3) Clarification of definition of deferred compensation

Under the proposal, deferred compensation plans would include any plan providing a benefit that, by its terms as applied to the specific employee population covered by the plan, cannot be paid during the current taxable year or the following year. This treatment would apply for purposes of the present-law rules relating to deferred compensation plans and for defining permissible benefits that may be offered by a VEBA. Present-law rules applicable to deferred compensation plans for independent contractors could be clarified to apply to other contractual arrangements for deferring payments to independent contractors.

10. Start-Up Expenditures

Present Law

Under present law, a taxpayer may elect to treat start-up expenditures as deferred expenses. Such deferred expenses are allowed as a deduction ratably over a period of not less than 60 months. Start-up expenditures are any amount paid or incurred in connection with investigating the creation or acquisition of an active trade or business, or creating such business, and which, if paid or incurred in connection with the expansion of an existing business, would be allowable as a deduction.

Administration Proposal

Under the Administration proposal, a taxpayer would be required to treat start-up expenditures as deferred expenses. The proposal would provide that such deferred expenses may be amortized over a prescribed period. Start-up expenditures would mean the same as under present law.

D. DEBT OBLIGATIONS ACQUIRED AT A DISCOUNT

1. Background: The Concept of Economic Accrual of Interest

Interest is commonly defined as the amount charged for the use or forbearance of money. There are several statutory provisions dealing with the treatment of items that serve as payments for the use of money but are not labeled as interest, or which are not structured as a percentage of the principal amount due. However, because the scope of the statutory provisions addressing the taxation of unconventional items of "interest" is not comprehensive, certain items of interest can be used to form the basis of tax-shelter investments.

Under generally accepted accounting rules and sound economic principles, the amount of interest attributed to the use of money for a period between payments is determined by applying the "effective rate of interest" on the loan to the "unpaid balance" of the loan for that period. The unpaid balance of a loan is the amount borrowed, plus interest earned, minus amounts paid. The effective rate of interest is a measure of the cost of credit, expressed as a yearly rate, that relates the amount and timing of values received to the amount and timing of payments made, and is thus a reflection of the cost of the amount borrowed for the time it is actually available. The effective rate of interest, which is a uniform rate over the term of the loan and is based on the amount of the loan and the repayment schedule, will produce the true cost of the amount borrowed when applied to the unpaid balance of the indebtedness for a given period. The concept of the true cost of the amount borrowed is referred to as the economic accrual of interest.

The concept of economic accrual of interest is applied in the statutory provisions dealing with original issue discount (OID). Consistent with the rules for computing OID, the Internal Revenue Service has ruled that (except in the case of certain short-term consumer loans) interest on discount obligations should be computed under the constant interest method, reflecting economic accrual. Rev. Rul. 83-84, 1983-1 C.B. 9. However, regardless of the propriety of economic accrual, taxpayers may attempt to challenge the Internal Revenue Service ruling on the basis of judicial decisions that approve the ratable accrual of interest over the loan term. *See James Brothers Coal Co.*, 41 T.C. 917 (1964), *appeal dismissed per stipulation*, (6th Cir. 1964). Further, there is a definitional gap in the tax law: market discount is not recognized as being the economic equivalent of interest.

2. Market Discount

Present Law and Background

Market discount, which arises when the value of a debt obligation declines after issuance, serves as a substitute for coupon interest. The holder of a market-discount bond receives some or all of his return in the form of price appreciation when the bond is redeemed at par at maturity.

Upon the disposition of a market discount bond that was issued by a corporation or a governmental unit and held for more than one year, capital gain treatment is accorded to gain attributable to market discount (sec. 1232). When a taxpayer borrows the funds used to purchase a market-discount bond, interest on the acquisition indebtedness can be deducted currently against ordinary income, subject to the limitations on the deductibility of investment interest. By making a leveraged purchase of a market-discount bond, a taxpayer effectively "converts" the ordinary income that is offset by interest deductions to capital gain and defers tax on that income.

Example.—A currently outstanding Treasury bond, issued in 1960 and maturing in May 1985, pays an annual interest rate of 4.25 percent and sells at a price of about $945 for each $1,000 bond. Hence, a taxpayer who purchased such a bond in February 1984 and held it to maturity would be assured of a $55 long-term capital gain (almost 6 percent of the investment) in addition to the coupon interest. More than one-half of the return to a holder of the bond comes in the form of long-term capital gain, only 40 percent of which is included in income and the taxation of which is deferred until the bond is sold or redeemed.

Administration Proposal

Under the Administration proposal, gain on the redemption or sale of a market-discount bond would be recognized as interest income to the extent of accrued market discount. This provision would operate much like the depreciation recapture rules of present law, except that recapture would occur at the time of a gift. Accrued market discount would be defined as the portion of the market discount that accrued while the taxpayer held the bond. Taxpayers could elect to accrue the discount under an economic accrual formula or under a simpler, but less generous, linear formula. This proposal would apply to obligations issued after the date of enactment. The proposal would not apply to tax-exempt obligations.

Possible Additional Proposal

The Administration proposal would prevent the use of market discount bonds to achieve conversion of ordinary income to capital gain, but would not discourage leveraged purchases to achieve deferral of tax liability. One option that would discourage leveraged purchases is to defer interest deductions that are allocable to indebtedness incurred to purchase or carry market-discount bonds issued after enactment to the extent such interest exceeds interest income from the bonds.

3. Zero Coupon Municipal Bonds

Present Law and Background

In general, gross income does not include interest on obligations issued by any political subdivision of a State (sec. 103(a)). The Internal Revenue Service has ruled that original issue discount (OID) on noninterest-bearing obligations issued by a municipality is exempt from tax under the general rule for interest on municipal obligations. Rev. Rul. 73-112, 1973-1 C.B. 47 (restating G.C.M. 10452, XI-1 C.B. 18 (1932)). The Internal Revenue Service has further held that this tax-exempt OID is apportioned ratably over the term of the obligations, among the original holder and subsequent purchasers. The application of these rules may permit the holder of a zero coupon municipal bond to generate an artificial loss on disposition 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, is reduced by the amount treated as accrued tax-exempt interest (determined by reference to the holder's ratable share of OID), even though the market price of the bond is likely to reflect the (slower) economic accrual of interest. It appears to be the Internal Revenue Service position that no loss is allowable based on the accrual of tax-exempt OID; however, taxpayers are taking the position that such losses are allowable.

Prior to 1982, holders of OID bonds issued by corporations were also required to apportion OID ratably over the term of the obligations. TEFRA included a provision that requires the economic accrual of OID on bonds issued by corporations and other juridical entities.

Example.—A, an individual taxpayer, acquires a 20-year noninterest-bearing municipal bond with a face amount of $1,000 for a price of $200 on the date of issue. Under Internal Revenue Service rulings, $40 of OID accrues for each year the bond is held. Assume that interest rates are stable and there is no fluctuation in the yield to maturity of the bond. After one year, A disposes of the bond for $217 (a price reflecting the economic accrual of $17 of interest). Under present law, taxpayers argue that A is entitled to treat $40 of the amount realized as tax-exempt interest income. The difference between the balance of A's amount realized ($177) and A's $200 basis in the bond ($23) is claimed as a deductible loss.

Recently, there has been a significant increase in issuance of zero-coupon tax-exempt bonds.

Possible Proposal

Tax-exempt OID on municipal bonds could be accrued under the economic constant interest method. This could be achieved either with legislation or administratively. To prevent subsequent holders of existing bonds from taking advantage of the possible loophole under present law, the effective date of this proposal could be for obligations issued after the date of enactment of the Tax Equity and Fiscal Responsibility Act of 1982 *and* purchased after the date of committee action on the proposal. Alternatively, the proposal could be made to apply only to bonds issued after the date of committee action on the proposal.

4. Certain Governmental Obligations Issued at a Discount

Present Law and Background

Special rules apply to governmental obligations (Treasury bills) that are issued at a discount and payable without interest at a fixed maturity not exceeding one year. The acquisition discount is not considered to accrue until the obligation is paid at maturity or otherwise disposed of, regardless of whether the taxpayer uses the accrual or the cash method of accounting (sec. 454(b)). Also, under regulations, periodic inclusion of original issue discount is not required for cash basis taxpayers in the case of obligations with a maturity of one year or less (e.g., bank certificates of deposit). Taxpayers who make leveraged purchases of obligations eligible for the special rules are able to defer tax liability on unrelated ordinary income.

Example.—On December 1, 1983, a taxpayer buys $5 million of Treasury bills maturing in February 1984 for $4,925,000. The taxpayer finances them through a repurchase agreement, or "repo." Under the terms of the repo, the taxpayer sells the bills on December 1 for $4,925,000 and agrees to repurchase them on January 2, 1984, for $4,963,000, which is what the bills will be worth on that date if interest rates do not change. The tax law generally treats repos as debt, in which case the $38,000 difference between the original purchase price and the repurchase price is deductible as interest. If the cash-basis taxpayer pays this interest on December 31, 1983, the interest is deductible in 1983. The taxpayer then sells the T-bill on January 2, 1984, for (say) $4,963,500, providing an economic profit of $500 (since interest rates declined). The taxpayer reports the $38,000 of ordinary income from the T-bill and the $500 short-term capital gain in 1984, thereby generating a one-year tax deferral on $38,000.

Year-end transactions of this sort are common on and off Wall Street.

In a report issued by the Committee on Commodities and Financial Futures of the New York State Bar Association Tax Section on February 2, 1984, it is asserted that a repo that is fixed as to interest rate and term, but which does not go to the maturity of the repoed security, is the economic equivalent of a long forward contract to purchase the security when the repo matures and should be treated as such for tax purposes. Under this analysis, present law should not treat the seller-creditor as the owner of a Treasury bill on which discount is accruing, nor as being liable on a debt on which interest can be deducted. Rather, the seller-creditor is properly viewed as the holder of a position in personal property, subject to the loss-deferral provisions of the tax straddle rules.

Others have argued that this tax shelter does not work under present law because the T-bill and the repo constitute a straddle subject to the anti-straddle rules of present law. However, the Bar report disputes this analysis.

In view of this uncertainty, the committee may wish to consider legislation to eliminate this tax shelter.

Possible Proposal

Interest incurred to purchase or carry a discount obligation whose term to maturity is one year or less, and discount on which is eligible for tax deferral, would not be deductible until the interest on the securities is included in taxable income. Alternatively, taxpayers could be required to accrue discount on these securities when they are debt-financed. Either of these proposals would deal with leveraged purchases of short-term discount obligations.

The committee may also want to reconsider the scope of the provisions that permit tax deferral on Treasury bills, which now apply to everyone. One possibility would be to require that taxpayers who are on the accrual method of accounting and cash-basis taxpayers who acquire short-term discount governmental obligations in the normal course of a trade or business account for the acquisition discount on T-bills on the accrual basis, regardless of whether the obligation is debt-financed.

5. Income From Factoring Trade Receivables

Present Law and Background

A form of discount transaction occurs when a seller of goods or services sells on credit rather than for cash, the seller may take from the purchaser a receivable—a transferable promise to pay cash in the future. A common financing technique is for the seller to then sell the receivable to a third party (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 received and the amount the factor paid for the receivable. When the seller is a U.S. corporation and the factor is a related foreign corporation, the net result can be the equivalent of a tax-free distribution of low taxed foreign earnings. If the seller is a related foreign corporation the result can be the shifting of profits to a tax-haven.

A number of issues have arisen under present law as to the tax-treatment of such a factoring transaction when the factor is a controlled foreign corporation related to the seller. Arguably, the factoring income could be subpart F income as interest or as income from the performance of services for a related party. However, the IRS has held in one instance that factoring income was not interest for purpose of subpart F (private letter ruling 8338043, June 17, 1983). It has not ruled on the services income issue. The purchase of the receivable of a U.S. person from the related U.S. corporation could be treated as an investment in U.S. property on which the U.S. shareholders of the controlled foreign corporation would be taxable (section 956). It might also be argued that a foreign corporation factoring U.S. receivables is engaged in business in the United States, and that the factoring income is subject to U.S. tax.

In each of the above cases, taxpayers have taken positions which, if sustained, would result in no current U.S. tax either to the CFC or to its U.S. shareholders. The result has been a growth in this offshore factoring and, consequently, tax free repatriation of foreign earnings.

Administration Proposal

The proposal would treat a controlled foreign corporation's income from factoring for related parties as foreign personal holding company income. Thus, when a controlled foreign corporation collects (gets cash for) a receivable that (1) it bought from a related person, and (2) the related person had taken in exchange for inventory (or services), its factoring income would be tax-haven type income, and its U.S. shareholders would be currently taxable on that income (under Subpart F). This rule would apply whether or not the related person is a U.S. person.

In addition, the proposal would treat certain factoring like loans from controlled foreign corporations to their U.S. shareholders. The proposal would amend the definition of U.S. property (in Code sec. 956) to include any receivable 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 would be currently taxable on the amount that it paid for the receivable (up to the amount of the foreign corporation's earnings and profits). The proposed Foreign Sales Corporation Act of 1983, H.R. 3810, and its companion bill, S. 1804, contain these provisions.

E. COMPLIANCE

Present Law and Background

Present law contains a number of administrative and compliance provisions that address the problem of tax shelters. Some of these are focused directly on tax-shelter issues while others have a more general application, but arose primarily out of concerns over tax shelters. These provisions include (1) penalties for (a) overvaluations, (b) substantial understatements of tax, (c) promoting of abusive tax shelters, and (d) aiding and abetting an understatement of tax; (2) procedures for unified audits of partnership; and (3) interest rates on deficiencies that are adjusted twice a year and provide for compounding.

In 1981, the Congress increased the negligence penalty and adopted a penalty on understatements of tax that are attributable to overvaluations of property. This later penalty ranges from 10 to 30 percent of the tax owed depending on the extent of the valuation error. The interest rate on deficiencies was also increased from 90 percent of prime to 100 percent of prime in 1982.

Starting in 1983 (as part of The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA)), the Congress again increased the interest rate by providing for daily compounding of interest and a semiannual adjustment of the rate. To conform the fraud penalty to changes made in the negligence penalty in 1981, a time-sensitive portion was added to the penalty. In an effort to curtail the most abusive tax shelters before investors enter into them or file returns claiming improper deductions or credits, the Congress adopted three new penalties in TEFRA. First, there was a $1,000 civil penalty for aiding and abetting in the preparation of returns or other documents which the preparer knows to be false. Second, TEFRA provided for a penalty on promoters of abusive tax shelters equal to $1,000 or 10 percent of their gross income from the promotion. Third, in an effort to increase the cost of claiming doubtful positions while hoping that they would escape detection, TEFRA contained a 10-percent penalty on substantial understatements of tax when there is inadequate authority for the position supporting them.

TEFRA also provided for streamlined partnership audit and litigation procedures. These will allow the Service to effectively examine the issues affecting a partnership's various partners in one proceeding.

TEFRA also provided for significant improvements in the information reporting system to assure a more accurate reporting of income.

Proposals Reported by the Senate Finance Committee

In 1983, the Senate Committee on Finance recommended five compliance amendments that would affect tax-shelter activities directly (contained in the Committee's reconciliation provisions in S. 2062, as reported by the Senate Committee on the Budget).

First, the Finance Committee recommended requiring any person who organizes investment plans or arrangements or other plans or arrangements and who makes representations as to the tax benefits of the arrangements to maintain a list of his customers including necessary identifying information. These lists would be available for inspection by the Internal Revenue Service. This amendment is intended to permit the Internal Revenue Service to identify all the purchasers of a questionable tax shelter directly rather than through its normal audit selection process.

Second, the Finance Committee recommended a 50-percent increase in the interest rate in tax shelter cases. This higher rate would apply to both deficiencies and overpayments and is intended to encourage more prompt settlement of cases by both taxpayers and the government.

Third, the amendments would increase the penalty on promoters of abusive tax shelters from the greater of 10 percent of gross income from the activity or $1,000 to 20-percent or $2,000. In addition, the Committee may want to consider providing that once the Internal Revenue Service has proven liability for the penalty, the promoter must bear the burden of proof on the issue of the amount of the liability.

Fourth, the amendments also would give the Treasury authority to bar from practice before the Treasury or Internal Revenue Service any appraiser who has violated the standards of the aiding and abetting penalty.

Finally, the Finance Committee has recommended adoption of reporting requirements on the discharge of indebtedness. These reports would be required when a lender forecloses or acquires property in satisfaction of a debt or when the security for a loan has been determined to have been abandoned. Reporting would also be required if the lender claims a bad debt deduction, even if property has not been foreclosed or otherwise acquired. The purpose of this rule is to enable the Internal Revenue Service to detect circumstances in which taxpayers should be reporting income from the discharge of indebtedness and the recapture of previously allowed tax benefits.

Possible Additional Proposals

The Committee may wish to consider whether reporting should be required when partnership interests are transferred. When a partnership interest is sold or exchanged, the transferor partner will typically have a reportable gain or loss on the sale. In addition, if the value received for the interest is attributable to appreciated inventory and unrealized receivables which could produce ordinary income if sold by the partnership,[58] the transferor will be

[58] The Code treats as unrealized receivables various amounts that would be subject to recapture as ordinary income if property were sold directly by the partnership.

treated as having realized ordinary income. Such reporting would require the partnership to inform the buyer, the seller, and the Internal Revenue Service of the fair market value of the inventory and unrealized receivable.

Another area in which additional reporting could improve compliance relates to the deductibility of contributions to individual retirement accounts (IRAs). Under present law, an individual generally may deduct the amount of a qualified contribution to an IRA. These contributions may be made, for any year, at any time during the year or before the due date of the return for that year. The Committee may wish to consider clarifying that the Internal Revenue Service has the authority to require the trustee or issuer of an IRA to file an annual report with respect to the IRA. In addition, this annual report could require the trustee or issuer to specify the taxable year to which an IRA contribution is attributable.

A tax shelter that is currently popular is the individually designed investment that produces enough in tax credits to eliminate the taxpayer's current and prior 3 years of tax liability. Typically, the investor invests no hard cash but assigns the refunds generated by the credit carrybacks to the promoter. These refunds are available on an accelerated basis through the tentative adjustment provisions of section 6411 which require the Internal Revenue Service to make the refunds within 90 days without audit. Many of these schemes are abusive when examined; however, the Service cannot deny the refund under section 6411 but must instead assert a deficiency after the refund is made. The Committee could consider limiting the circumstances in which accelerated refunds may be obtained, or allowing the Service to delay or deny refunds in certain cases.

F. MISCELLANEOUS

1. Charitable Contributions

Present Law and Background

In general

Present law (sec. 170) allows a deduction, subject to certain limitations, for charitable contributions of cash or property. If the donor contributes property to a public charity, the amount of the contribution generally equals the fair market value of the property at the time of the contribution.[59] Treasury regulations define fair market value as the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts.[60]

In general, a taxpayer may not deduct that portion of the appreciation in value which would not have qualified as long-term capital gain had the property been sold at the date of the contribution.[61] Thus, in order to deduct the full appreciated value of the donated property, the property must be a capital asset, and the donor must have held the property for more than one year before donating it to a public charity.

Tax shelter opportunities

Because a donor generally may deduct the full fair market value of appreciated capital-gain property without having to pay tax on that appreciation, and because there are no objective standards for valuing many types of donated property (such as art works, antiques, unimproved land, or closely held stock), charitable contributions may be an attractive form of tax shelter.

For example, assume that an individual purchases a work of art for $10,000, but is able to have the art appraised, a year or more later, at a value of $50,000. By donating the art to a museum, the individual may claim a $50,000 tax deduction. Assuming that the individual is in a 50 percent tax bracket, this deduction is worth $25,000, or 250 percent of the original purchase price.[62]

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[59] See Treas. reg. sec. 1.170A-1(c). Most other tax deductions are either limited to the basis of property (e.g., losses under sec. 165) or else gain is recognized when appreciated property is used to pay a deductible expense.

[60] For contributions of inventory-type property, fair market value is the price which the taxpayer would have received if he had sold the property in the ordinary course of business. Treasury reg. sec. 1.170A-1(c)(2).

[61] Sec. 170(e)(1)(A).

[62] Under the Tax Reform Act of 1969, charitable deductions for donations of artistic or literary property by the creator of the property are limited to the donor's basis in the donated property. However, collectors or other owners of such property (other than the creator and persons whose basis in the property is determined by reference to the creator's basis) may receive a deduction for the full value of the property if held by them for more than one year and donated to a public charity.

In addition to situations where individuals buy items on their own initiative specifically for contribution after expiration of the one-year capital gains holding period, in recent years opportunities to offset income through inflated valuations of donated property also have been 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 a year and a day, 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.[63]

One popular tax shelter has involved the purchase of precious gems for donation to a museum.[64] In a typical transaction, an individual purchases gems from a promoter at a nominally "wholesale" price. The promoter represents that the gems, at the time of donation, will have an appraised value substantially in excess of the purchase price. In certain cases, the gems are subjected to chemical treatments which allegedly increase their value. After holding the gems for at least 1 year, the taxpayer donates them to a museum, claiming a deduction based on an expert appraisal of the value of the gems. This value is frequently 5 or more times the price the individual actually paid for the gems. Thus, the taxpayer may receive a tax benefit 2 or 3 times the initial investment.

While some of the most flagrant overvaluation cases which have come to attention have involved gems donated to museums, in other instances deductions denied by the Internal Revenue Service on the basis of overvaluation have involved contributions of other types of property, such as interests in real estate, made to other types of donees, such as educational institutions.

For example, in 1982 the Tenth Circuit held that the Service could require Brigham Young University to provide the names of all individuals who had made charitable contributions in kind (other than securities) to the university over the years 1976-1978. The Service had previously disallowed approximately $16 million out of a total $18 million claimed as charitable deductions by 162 individual donors of property to the university. The great majority of these overvaluations involved donations of art objects and mining claims. The Court held that since the prior audits "revealed that in each instance the amount of the contribution was overvalued, and generally grossly overvalued," the Service had established the necessary basis for enforcing the summons to obtain the

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[63] See, e.g., Speiller, "The Favored Tax Treatment of Purchasers of Art," 80 Colum. L. Rev. 214 (1980); Note, "Tax Incentives for Support of the Arts," 85 Dickinson L. Rev. 663, 681-686 (1981); Anthoine, "The Collector of Taxes v. the Collectors of Objects," 59 *Taxes* 917, 923 (1981) ("The IRS has had a real problem in keeping up with the tax shelter programs that have been devised by promoters to take advantage of the charitable deduction ***"); Melevin, "Valuation of Charitable Contributions of Works of Art," 60 *Taxes* 756, 761 (1982)("The IRS has experienced difficulties, in these situations [contribution shelters], in attempting to disallow deductions under the fair market value test, since quality appraisals are easily obtained by the taxpayer").

[64] See *Wash. Post*, March 29, 1983, p. A-1; March 30, 1983, p. A-1; and April 15, 1983, p. A-1 (concerning donations to the Smithsonian Institution).

names of other donors of property in kind, including property other than art works and mining claims.[65]

Determination of fair market value

To provide an attractive tax shelter, donated property must be appraised at a value significantly in excess of the purchase price. The validity of these appraisals, in turn, depends, in part, upon the applicable definition of fair market value.

The courts have generally held that fair market value is the generally available retail price in the relevant market.[66] For example, in *Goldman* v. *Commissioner*, 388 F.2d 476 (6th Cir. 1968), *aff'g* 46 T.C. 136 (1966), the court held that the value of donated books should be computed based on the price that an ultimate consumer would pay, rather than a dealer buying to resell. However, the determination of fair market value must be based on the facts of the particular case.

In Rev. Proc. 66-49, 1966-2 C.B. 1257, the Internal Revenue Service provided guidelines for appraisals of contributed property for charitable deduction purposes. The revenue procedure stated that all factors bearing on the value of donated property are relevant including, where pertinent, the cost or selling price of the item, sales of comparable properties, cost of reproduction, opinion evidence, and appraisals. The revenue procedure stated further that appraisals and other opinion evidence will be given appropriate weight only when supported by facts having strong probative value.

Rev. Rul. 80-69, 1980-1 C.B. 55, stated that the best evidence of the fair market value of an assortment of gems was the price at which a taxpayer bought the gems from the tax shelter promoter. The ruling involved a taxpayer who purchased an assortment of gems from a promoter for a price of 500x dollars. The promoter asserted that the price was wholesale, although the promoter and other dealers engaged in numerous sales at similar prices with other individuals who were not dealers in gems. The taxpayer contributed the gems to a museum 13 months after purchase and claimed a charitable contributions deduction of 1500x dollars. According to the ruling, the best evidence of fair market value depends on actual transactions and not on an artificially calculated estimate of value.[67]

In *Anselmo* v. *Commissioner*,[68] the Tax Court held that the fair market value of unset gems was the price that would have been paid by a jewelry store to a wholesaler to obtain comparable items.

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[65] *U.S.* v. *Brigham Young Univ.*, 679 F.2d 1345 (10th Cir. 1982), *petition for cert.* filed by taxpayer (Oct. 19, 1982). See also *L.A. Times*, June 2, 1982, p. 1 (IRS agents charge in court affidavits that California university and museum officials had falsified documents on donations of art works at overstated valuations allegedly furnished by dealer).

[66] Treasury Regulations under the estate and gift taxes state that fair market value is the price of an item in the market in which that item is most commonly sold to the public, taking into account the location of the item wherever appropriate. Treas. Reg. sec. 20.2031-1(b) (estate tax); sec. 25.2512-1 (gift tax). These regulations are not binding for charitable contribution cases. However, they appear to state the general rule applicable in those cases. *See Anselmo v. Comm'r*, 80 T.C. 872 (1983).

[67] In another 1980 ruling, the Service stated that the best evidence of the value of Bibles purchased in large quantity from a promoter at a supposed discount from retail, and donated 13 months later to charities, was the price at which similar quantities of Bibles were actually sold in arm's-length transactions not the alleged value assigned to them by the promoter. Rev. Rul. 80-233, 1980-2 C.B. 69.

[68] 80 T.C. 872 (1983) (on app. by taxpayer to 11th Cir.).

The case involved a taxpayer who donated some 461 colored gems to the Smithsonian Institution approximately 9 months after purchasing them.[69] The taxpayer claimed a charitable contribution deduction in an amount ($80,680) more than 5 times the purchase price ($15,000). The appraised value of the gems was based on the retail prices charged by jewelry stores for jewelry containing similar gems. The taxpayer purchased the gems from a promoter which had promised to obtain appraisals of 5 times the purchase price as part of the contract of sale.

The court held that the ultimate consumers of gems like those contributed were the jewelers who set the gems into finished items of jewelry. Accordingly, the effective retail market for the gems (as opposed to the finished jewelry) was the market for sale to the jewelers. Based on these holdings, the court affirmed the Service's determination of the fair market value of the gems as $16,800 (approximately 10 percent more than the purchase price).

Enforcement and administration

The Internal Revenue Service has succeeded in challenging overvaluations of charitable contributions in various instances.[70] However, the effort to limit charitable deduction and other tax shelters presents problems of enforcement and administration. One of these problems arises from the volume of these cases.

A further problem arises in detecting excessive charitable deductions at the administrative level. The Art Advisory Panel of the Internal Revenue Service, composed of 22 outside art experts, has helped the Service to detect excessive valuations in the art donation area. In the 8 years prior to 1983, the panel recommended $24 million in reductions out of $141 million of appraised contributions.[71] The Service has also 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. Because of the subjective nature of valuation, taxpayers may continue to play the "audit lottery" and claim excessive charitable deductions.

Administration Proposal

Under the Administration if a donor had not held donated property for more than three years, the amount deductible for a charitable contribution of property (including capital-gain property) generally would be limited to the donor's cost for the property. However, in the case of a capital asset which is readily tradable on an established securities market, the full fair market value would be deductible where the donor had held the donated property for more than one year, as under present law. Contributions of property held for more than three years also would be deductible as under present law.

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[69] Under the then applicable rules, property held for 9 months qualified for long-term capital gains treatment.

[70] *See*, e.g., *Farber* v. *Comm'r*, 33 T.C.M. 673 (1974), *aff'd* 76-1 USTC para. 9118 (2d Cir. 1976) ($150,000 deduction reduced to $10,000; *Vander Hook* v. *Comm'r*, 36 T.C.M. 1394 (1977) ($12,000 deduction reduced to $1,200).

[71] *N.Y. Times*, May 2, 1983, p. D-1.

Also, the Administration proposal would modify the present-law penalty on understatements of tax that are attributable to overvaluations of property, including overstated deductions for contributions of property. Under present law, the penalty does not apply with respect to property that has been held by the taxpayer for more than five years. The proposal would apply the overvaluation penalty to all overvaluations of property without regard to the length of time the donor had held the property.

2. Investment Tax Credit for Dairy Property

Present Law

Present law provides for an investment tax credit of up to 10 percent of the cost of certain tangible depreciable property having a useful life of three years or more. Under present law, certain livestock (including dairy cattle) qualifies for a 10-percent investment tax credit. The credit base is reduced by the amount (if any) realized on a disposition of substantially identical livestock within the period beginning six months before, and ending six months after, the acquisition of the property. The investment tax credit is also available for certain farm machinery and equipment and for single-purpose structures designed, constructed, and used for the care and feeding of a particular type of livestock.

In addition to the investment tax credit, depreciation is available for livestock acquired for work, breeding, or dairy purposes, as well as for farm buildings (other than owner residences), machinery, and physical farm property other than land. For property (including dairy cattle) placed in service after 1980, depreciation is calculated according to the accelerated cost recovery system (ACRS).

Possible Proposal

A proposal, as reflected in H.R. 4701 (introduced by Mr. Stark), would deny an investment tax credit for dairy property for any year during which a Federal dairy program is in effect. For this purpose, dairy property would include any property which is used by the taxpayer predominantly in the trade or business of dairy farming or leased for use in such trade or business. A Federal dairy program would mean any Federal program (1) which is operated primarily for the purpose of supporting the price farmers receive for milk, or (2) under which farmers are paid for reducing the quantity of milk marketed for commercial use.

3. "Golden Parachute" Compensation Arrangements

Present Law and Background

An employer may enter into an agreement to compensate a management employee in the event employment is terminated within a specified period after a change in the ownership or control of the employer. Under present law, the tax treatment of the employee and the employer depends on whether the compensation is paid to a funded plan or directly to the employee. If the agreement is funded, the employee is generally required to include the compensation in gross income at the earlier of the time the rights of the employee are (1) transferable or (2) not subject to a substantial risk of forfeiture.[72] The employer is not entitled to deduct the compensation until the time the employee includes the amounts in gross income. If payments are made directly to an employee, they are generally includible in the employee's gross income when paid and deductible by the employer at that time.

Present law provides that amounts which constitute unreasonable compensation are not ordinary and necessary business expenses and, therefore, are not deductible.

In recent years, employers have established "golden parachute" arrangements that are designed to provide compensation to selected employees in the event there is a change in ownership or control of the employer. These arrangements typically guarantee continued compensation to key employees for a specified period after the takeover and generally cover only the top management employees.

Possible Proposal

Under a proposal, as reflected in H.R. 4357 (introduced by Mr. Stark), if the consideration to be received by a shareholder (one-percent, or more) for stock of a corporation exceeds the prevailing market price at the time of the transaction, then gain on the transaction would be treated as ordinary income. In addition, no deduction would be allowed to the corporation for any amount attributable to the transaction.

Under the proposal, no deduction would be allowed for any amount paid or incurred (or property to be transferred) pursuant to a management protection agreement. A management protection agreement would include any agreement (1) that discriminates in favor of corporate employees who are officers, shareholders, or highly compensated, and (2) provides for a payment (or a transfer of property) to an employee if employment is terminated within a specified period after a change in ownership or control of the corporation.

The proposal would require that the present value of the aggregate amount to be received under a management protection agreement be included in the gross income of the employee as ordinary income in the taxable year employment is terminated.

4. Limitations on Depreciation and Investment Tax Credit for Expensive Automobiles

Present Law

A taxpayer who acquires an automobile for use in a trade or business and uses it for such business purposes is entitled to claim an investment tax credit and cost recovery deductions under the Accelerated Cost Recovery System (ACRS), in addition to deductions for operating and maintenance expenses.

The amount of the regular investment credit for automobiles is 6 percent of cost. Basis adjustment is required in this case, so that ACRS deductions are allowed for 97 percent of cost. Alternatively,

[72] Sections 83 and 402(b).

the taxpayer may elect a reduced investment credit equal to 4 percent of cost, in which case ACRS deductions are allowed for 100 percent of cost. In either case, 25 percent of the amount that may be written off is deductible in the first year, 38 percent is deductible in the second year, and the remaining 37 percent is deductible in the third year.

Possible Proposal

A proposal, as reflected in H.R. 4135 (introduced by Mr. Stark), would limit the tax benefits otherwise available to owners of expensive automobiles used for business purposes.

Under the proposal, the investment credit and ACRS deductions would apply only to the first $15,000 of the cost of a passenger automobile placed in service in 1984. Accordingly, if a taxpayer purchased for $43,000 a car the use of which otherwise qualified for business deductions, no investment credit or ACRS deductions would be allowed for $28,000 of the cost. The $15,000 ceiling would be indexed to the automobile component of the Consumer Price Index for all urban consumers, and this adjusted ceiling would apply for automobiles placed in service after 1984. The limitation under the proposal would not apply to ambulances, hearses, vehicles used by the taxpayer directly in the trade or business of transporting persons or property (such as airport limousines), or vehicles rated at more than 6,000 pounds gross vehicle weight.

5. Limitation on Cover Over (Payment) of Certain Federal Excise Taxes to Puerto Rico and the Virgin Islands

Present Law and Background

Present law imposes a special excise tax 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 had been manufactured in the United States (sec. 7652). This tax is in lieu of the excise tax that would be imposed on such articles if they had been manufactured in the United States or imported from another country.

Revenues collected from this tax on articles coming into the United States from Puerto Rico or the Virgin Islands are covered over (paid) to the treasury of that possession. Present law imposes no restrictions on the use of these revenues by Puerto Rico or the Virgin Islands.

The Government of Puerto Rico presently sponsors a redistillation program under which spirits originally distilled in the United States are transported to Puerto Rico and redistilled in that possession. Following redistillation, the spirits are returned to the United States for processing and marketing. As a result of their redistillation in Puerto Rico, the Puerto Rican Government receives a payment of $10.50 per proof gallon (i.e., the amount of excise tax imposed on distilled spirits) with respect to these distilled spirits.

Possible Proposal

A possible proposal, as reflected in H.R. 4702 (introduced by Mr. Stark and Mr. Moore), could provide that the special excise tax/

cover over provision for articles coming into the United States from Puerto Rico or the Virgin Islands does not apply if any one of the following conditions is satisfied:

(1) In the case of distilled spirits, if the original distillation of the spirits occurred other than in Puerto Rico or the Virgin Islands;

(2) In the case of any article subject to Federal excise tax, if less than 50 percent of the value of the article was attributable to Puerto Rican or Virgin Islands input; or

(3) In the case of any article subject to Federal excise tax, if the Government of Puerto Rico or the Virgin Islands provides a subsidy to the industry involved of a kind different from that paid to industries whose products are not subject to Federal excise tax.

Under the proposal, the value of an article could be determined at the point of entry into the United States and would be based upon the cost of materials and labor used in producing the article.

The proposal could exempt rum coming into the United States from Puerto Rico and the Virgin Islands.

The effect of the proposal would be to continue taxing articles no longer treated as being of Puerto Rican or Virgin Islands manufacture at the present rate, but to eliminate the present cover over of the tax revenues to Puerto Rico and the Virgin Islands.

6. Avoidance of Rules Relating to Transfers of Depreciable Property Between Related Taxpayers

Present Law and Background

In order to prevent tax-motivated transactions, transfers between related parties often receive special treatment under the Internal Revenue Code. One provision provides that a transferor will be treated as receiving ordinary income rather than capital gain on the transfer of property to a related party when that property is depreciable property in the hands of the transferee (section 1239).

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. As the Court in *Lan Jen Chu* stated:

> It would be a simple matter for a tax conscious inventor to sell his pending application to a controlled corporation, pay capital gains on the excess of the purchase price over his basis, and then, once the application has been approved, allow the corporation to write-off against ordinary income depreciation on the now stepped-up basis of the patent. Indeed, by immediately paying taxes on his profit at the favorable capital gains rate and thereby achieving long term avoidance of a comparable amount at ordinary income rates, *the result is very likely to be a net loss to the public fisc.* (Emphasis supplied.)

Possible Proposal

The provision of the Code relating to gains from the sale of depreciable property between related parties (section 1239) could be amended to treat a patent application as depreciable property, thus requiring that any gain recognized to the transferee be treated as ordinary income rather than capital gain. This solution also could be broadened to cover similar situations.

7. Nondiscrimination Rules Applicable to Statutory Fringe Benefits

Present Law and Background

Under present law, various provisions of the code granting favorable tax treatment to certain employee benefits contain rules denying the favorable treatment if the terms of the benefit plan discriminate in favor of officers, owners or highly compensated employees. These provisions include qualified pension plans, group-term life insurance, group legal services and dependent care assistance. Although these rules are somewhat different for each benefit, the nondiscriminatory nature of the plan is generally tested by treating all employers under common control as one employer. This is intended to prevent an employer from dividing his employees into different subsidiaries according to pay level and avoiding the purpose of the rules. Special rules require, for pension plans, that certain employees hired through a leasing organization are to be treated as employees of the firm actually using the services of the employees. In addition, all employees of an affiliated service group are treated as if employed by a single employer for purposes of certain fringe benefits. Plans provided under collective bargaining contracts are sometimes not subject to the nondiscrimination rules. Special optional rules are provided for cash-or-deferred arrangements, under which the nondiscriminatory nature of the plan is tested by comparing the percentage of pay deferred by the highest paid one-third of employees to the similar percentage for other employees.

Possible Proposals

Various proposals could be considered in order to improve the effectiveness of the nondiscrimination rules applicable to statutory fringe benefits. First, it could be made clear that the employee leasing rules require an employer to include his common-law employees as his own in testing for nondiscrimination under the Code, regardless of the existence of an intermediary employee leasing organization. Second, the affiliated service group rules could be changed to include broader related party rules and certain employee sharing arrangements. Third, the employee leasing and affiliated service group rules could be applied to all the nondiscrimination rules in the Code. Fourth, it could be made clear that benefits provided under collective bargaining contracts that cover primarily management employees or executives do not qualify for the collective bargaining exception to the nondiscrimination rules. Fifth, cash-or-deferred arrangements could be treated as nondiscriminatory only under the special rules applicable to these arrangements, rather than under the rules generally applicable to qualified plans that serve to allow employer social security taxes to be counted as employee deferrals. In addition, these special rules could be amended to provide that the lower paid group of employees, for purposes of testing nondiscriminatory operation of the plan, includes only those employees with salaries below a fixed dollar amount. Finally, consideration could be given to applying uniform nondiscrimination rules to all fringe benefits receiving favorable tax treatment.

8. Withdrawals of Contributions to Pension Plans

Present Law and Background

Under a tax-qualified pension, profit-sharing, stock bonus plan ("qualified pension plan"), qualified annuity plan, a tax-sheltered annuity, or a government plan, contributions may be made by (1) the employer, (2) the employees, or (3) both. Thus, present law permits a qualified pension plan to be funded solely by employee contributions.

Employee contributions to a qualified pension plan generally are not deductible by the employee. Contributions by an employee that meet certain requirements, which are 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 pension plan at any time without penalty. In addition, the first withdrawals of nondeductible contributions are treated as a return of the nondeductible contributions, which are not includible in gross income. After the balance of the nondeductible contributions has been exhausted, other withdrawals are considered to be income. If the same amounts had been contributed to the purchase of a tax-deferred annuity contract, a premature distribution penalty tax would apply and amounts distributed would be treated as coming first out of earnings on the contract.

Special rules apply to withdrawals of deductible contributions made under a cash-or-deferred arrangement. These benefits are not to be distributable earlier than upon retirement, death, disability, or separation from service, hardship or the attainment of age 59½.

Issues

Under current Internal Revenue Service procedures, a financial institution may establish a qualified master pension plan in which many employers participate. Several master plans have been adopted that are limited to nondeductible employee contributions. At least one such plan offers participants check writing and credit card privileges on the amounts contributed; these employee contributions master plans have been sold as tax-deferred savings (and checking) accounts, rather than as retirement savings vehicles. With respect to withdrawals from cash-or-deferred arrangements, the term "hardship" has not yet been defined in regulations. If withdrawal were allowed relatively freely, these arrangements could become subject to abuse.

In the Tax Equity and Fiscal Responsibility Act of 1982, Congress imposed certain withdrawal restrictions on tax-deferred annuity contracts in order to discourage their use for short-term investment and income tax deferral. The issue that the committee may wish to consider is whether similar restrictions should be imposed on nondeductible employee contributions to qualified pension plans in order to discourage their use for short-term investment and income tax deferral.

Prior Committee Action

H.R. 4170, as reported by the Committee on Ways and Means on October 21, 1983, contains a provision that permits individuals to make nondeductible contributions to individual retirement arrangements (IRAs). In order to make the treatment of these nondeductible contributions consistent with the rules relating to tax-deferred annuities, the committee added restrictions on the withdrawals of nondeductible IRA contributions and rules that determines the order in which nondeductible contributions are withdrawn from an IRA.

Possible Proposals

Under the proposal, nondeductible employee contributions generally would be subject to rules similar to the rules relating to nondeductible IRA contributions and tax-deferred annuities. These rules would provide that withdrawals of nondeductible employee contributions would be treated as coming first out of earnings on the contributions and then out of the nondeductible contributions. In addition, a 10 percent penalty tax would be imposed on the amount of the withdrawal that is includible in gross income, to the extent that the withdrawal is made before the participant separates from service, attains age 59½, dies, or becomes disabled.

In order to ease the recordkeeping burdens that may result from the ordering rules with respect to nondeductible contributions, the proposal could provide that nondeductible contributions are deemed to be the last amounts withdrawn from a plan.

With respect to cash-or-deferred arrangements, the term "hardship" could be limited to substantial and unforeseen financial hardships, such as large uninsured medical expenses.

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