[JOINT COMMITTEE PRINT]

DESCRIPTION OF BILLS RELATING TO THE TAX TREATMENT OF MORTGAGE RELATED AND OTHER ASSET BACKED SECURITIES (S. 1959 AND S. 1978) AND ENVIRONMENTAL ZONES (S. 1839)

Scheduled for a Hearing

before the

SUBCOMMITTEE ON
TAXATION AND DEBT MANAGEMENT

of the

SENATE COMMITTEE ON FINANCE

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INTRODUCTION

The Subcommittee on Taxation and Debt Management of the Senate Committee on Finance has scheduled a public hearing on January 31, 1986, on S. 1959 (introduced by Senator Chafee), S. 1978 (introduced by Senators Cranston, D'Amato, Dixon, and Dodd), and S. 1839 (introduced by Senator Chafee). S. 1959 and S. 1978 relate to the tax treatment of mortgage related and other asset backed securities. S. 1839 relates to the tax treatment of deductions and credits for expenditures in environmental zones.

The first part of the pamphlet [1] is a summary. This is followed in he second part with a description of S. 1959, S. 1978, and S. 1839, ncluding present law, explanations of the bills and effective dates.

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Description of Bills Relating to the Tax Treatment of Mortgage Related Securities (S. 1959 and S. 1978) and Environmental Zones (S. 1859)* (JCS-3-86), January 30, 1986.

I. SUMMARY

A. Tax Treatment of Mortgage Related and Other Asset Backed Securities

S. 1959 (Senator Chafee) and S. 1978 (Senators Cranston, D'Amato, Dixon and Dodd)

Present Law

Under present law, income producing assets, such as home mortgages or other debt obligations, may be owned directly by individuals, or may be owned indirectly by means of ownership in a corporation or beneficial interest in a trust that holds such assets. If such obligations are held by a corporation or as an association taxable as a corporation, income tax may be imposed at both the corporate and individual levels on the income generated by such assets.

Under present law, the grantor of a "grantor trust" is treated as the owner of the assets held by the trust. Under Treasury regulations, a trust that has more that one class of interests (e.g., if certain beneficiaries receive distributions of principal before other beneficiaries) is treated as an association taxable as a corporation, and not as a grantor trust.

The application of the present law rules relating to the treatment of original issue discount and market discount with respect to debt obligations that are prepaid is somewhat uncertain.

S. 1959

S. 1959 (introduced by Senator Chafee) would provide rules under which an entity that holds debt obligations, generally limited to mortgages on real property, could issue interests that entitle holders to receive specified cash flows generated by the mortgages, without the imposition of a corporate tax on the entity. Under the bill, such interests would be known as "collateralized mortgage securities" or "CMSs." CMSs could be issued by a corporation, trust, or partnership, and could be in the form of an ownership interest or a debt obligation. CMSs could be issued with different classes of maturities. Holders of the interests generally would be treated as owners of the underlying mortgages.

The bill also would prescribe rules for the taxation of holders of CMSs, including clarification of the application of the original issue discount and market discount rules to obligations whose maturity may be accelerated because of prepayments on the underlying obligations. The bill also would expand the reporting requirements of present law.

The bill generally woud apply to CMSs and debt obligations issued after the date of enactment.

S. 1978

S. 1978 (introduced by Senators Cranston, D'Amato, Dixon, and Dodd) would amend the grantor trust provisions of present law to permit a trust that has multiple classes of interests to be treated as a grantor trust in certain circumstances. The bill would apply to a trust that holds only "financial instruments" that are identified upon issuance of the interests in the trust and that may not be substituted for except in limited circumstances. A "financial instrument" would include most debt obligations, accounts receivable, and lease receivables. Holders of interests in such a grantor trust generally would be treated as holders of interests in the trust property.

The bill would apply to interests issued after April 27, 1984.

B. Tax Treatment of Deductions and Credits for Expenditures in Environmental Zones

S. 1839 (Senator Chafee)

S. 1839 (introduced by Senator Chafee) would modify tax incentives for certain types of investments in environmentally sensitive areas (environmental zones). In general, these modifications are intended to eliminate tax incentives for development in these areas. These areas would be designated by reference to specified Federal statutes.

II. DESCRIPTION OF THE BILLS

A. Tax Treatment of Mortgage Related and Other Asset Backed Securities

S. 1959 (Senator Chafee) and S. 1978 (Senators Cranston, D'Amato, Dixon, and Dodd)

Present Law

Taxation of Alternative Methods of Owning Income Producing Assets

Overview

Under present law, income producing assets (such as mortgage on real property or other debt obligations) can be owned directly or they can be owned indirectly by means of an equity interest i an intermediary entity. Income generated by property that i owned directly generally is taxed to the owner of the property Thus, in the case of property owned directly by an individual income from such property is subject to only one level of taxation Income from property owned indirectly may be subject to mor than one level of taxation, i.e., tax may be imposed both at th level of the intermediary holder and the indirect owner.

Whether more than one level of tax is imposed where incom producing property is held indirectly generally depends on whethe the intermediary entity is treated for tax purposes (1) as a separat taxable entity (such as a corporation or an association taxable as corporation), (2) as a complete conduit entity (such as a partnershi or S corporation), or (3) as a partial conduit entity (such as a trus or real estate investment trust) for which income is not taxed t the entity to the extent it is currently distributed to the entity' owners.

Direct ownership of income producing assets

Individual ownership

The most basic form of direct ownership of income producin assets is the holding of such assets by an individual. Where an indi vidual owns income producing assets directly, the individual gener ally includes all income generated by the property, and deducts al items of expense related to the property. When the individual dis poses of the property in a taxable transaction, the individual recog nizes gain or loss, which may be capital gain or loss.

Grantor trusts

A grantor trust is an arrangement under which legal title t property is transferred to a trustee, but the transferors retain cer ain powers over, or interests in, the trust so that the transferors re treated as retaining direct ownership of such property for Federal income tax purposes (secs. 671-679). Thus, income, deductions, nd credits of the grantor trust are attributed directly to the granors.[2]

ndirect ownership of income producing assets

Separate taxable entities—corporations

One form of indirect ownership of income producing property is he ownership of stock in a corporation that owns such property. orporations can be used to hold investment property or to engage n the active conduct of a trade or business.

Corporations generally are treated for tax purposes as separate axable entities, apart from their shareholders.[3] Thus, income arned by a corporation is taxed to the corporation. In addition, hen the after-tax earnings of a corporation are distributed to the orporation's stockholders as dividends, generally, such earnings lso are taxed to the stockholders.[4]

Interest on debt incurred by a corporation to finance the acquisiion of income producing assets generally is deductible to the corpoation incurring the debt. To the extent that income from debt-fianced property is paid to the debtholders in the form of interest, he interest deduction offsets any corporate level tax on such ncome, resulting in the imposition of only a single tax on the ncome, which tax is borne by the debtholder.

Complete conduit entities

Partnerships.—Another form of indirect ownership of income roducing assets is ownership of an interest in a partnership holdng such assets. A partnership generally is treated as a complete onduit for Federal income tax purposes.[5] Each partner accounts or his "distributive share" of the partnership's income, loss, deducion, and credit. The liability for income tax is that of the partner, nd not of the partnership, without regard to whether the income f the partnership is actually distributed to the partners. Partnership losses, deductions, and credits pass through to the partners and can be used to offset other income. In general, an entity is reated as a partnership if it is an unincorporated organization

[2] In some cases, persons other than the transferors are treated as owners of the trust's assets.

[3] Certain corporations may be treated as complete or partial conduit entities, however. *See* discussion of S corporations and real estate investment trusts, below.

[4] Under present law, an individual generally is allowed to exclude from taxable income up to $100 of dividends per year ($200 for a joint return) (sec. 116). Corporations are entitled to a dividends received deduction for 85 or 100 percent of dividends received (secs. 243-245). Section 311 of H.R. 3838, the Tax Reform Act of 1985, as passed by the House of Representatives on December 17, 1985, generally reduces the two-tier taxation of income earned by corporations by granting corporations a deduction equal to 10 percent of dividends paid out of earnings that have been subject to corporate level tax. This provision is effective for dividends paid in taxable years beginning after January 1, 1987 and is phased in over 10 years. In addition, sections 303 and 312 of H.R. 3838 lower the 85-percent corporate dividends received deduction to 80 percent for dividends received or accrued after December 31, 1985, and further lower such deduction to 70 percent corresponding to the phase-in of the dividends paid deduction. Further, section 313 of H.R. 3838 repeals the dividend exclusion for individuals, effective for taxable years beginning after 1985.

[5] A partnership is treated as an entity separate from its partners for purposes of calculating items of taxable income, deduction, and credit. It also is treated as an entity for purposes of reporting information to the Internal Revenue Service.

through, or by means of which, any business, financial operation or venture is carried on, and it is not treated as a corporation, a trust, or an estate.[6]

S Corporations.—Income producing property also may be owned indirectly through ownership of stock in an S corporation. Although S corporations are corporate entities, if an eligible corporation so elects, its shareholders generally may account for a proportionate amount of the corporation's items of income, loss, deduction, and credit under subchapter S of the Code (secs. 1361–1379). The S corporation itself generally has no tax liability for as long as the election is in effect.[7]

In general, a domestic corporation may elect to be treated under subchapter S if it has 35 or fewer shareholders (none of whom are corporations or nonresident aliens), has not more than one class of stock, and is not a financial institution, a life insurance company, or one of several other types of corporations.

Partial conduit entities

Real estate investment trusts.—Another form of indirect ownership is the ownership of shares or interests in a real estate investment trust ("REIT"). Under the provisions of the Code applicable to REITs (secs. 856–860), REITs generally are treated as conduits for Federal income tax purposes to the extent of the amount of its earnings that are distributed currently to shareholders. Conduit treatment is achieved by allowing the REIT a deduction for earnings distributed on a current basis. Thus, income that is currently distributed to shareholders is not taxed at the REIT level; income that is not currently distributed to shareholders is taxed at the REIT level, as in the case of ordinary corporations.

In general, an entity may qualify as a REIT if it is a trust or corporation with at least 100 different freely transferable interests, and would be taxable as an ordinary domestic corporation but for its meeting certain specified requirements. These requirements relate to the entity's assets being comprised substantially of real estate assets and the entity's income being in substantial part realized from certain real estate and real estate related sources.

The ability of a REIT to engage in regular business activities is limited by the requirement that income from the sale or other disposition of stock or securities held for less than 1 year, or real property held less than 4 years, must account for less than 30 percent of the REIT's income, as well as certain other requirements. Further, a 100-percent tax is imposed on gains from the sale of property held for sale to customers in the ordinary course of trade or business (other than foreclosure property).

If a corporation meets these requirements and elects to be treated as a REIT, it generally is subject to the regular corporate tax, but receives a deduction for dividends paid provided that the amount of its dividends paid is not less than an amount generally equal to 95 percent of its ordinary income. These dividends must be paid within a short period following the close of the REIT's taxable

[6] *See* discussion of entity classification, below.

[7] An S corporation may be subject to tax at the entity level under certain limited circumstances.

year and are generally includible as ordinary income to the shareholders.[8]

A REIT that realizes capital gain income may be subject to tax at the corporate level at capital gains rates. If, however, the REIT pays dividends out of such capital gains, the dividends are deductible by the REIT in computing its capital gains tax and are taxable as capital gains to the recipient shareholders.

Trusts.—Another form of indirect ownership of property is ownership of the beneficial interest of property that is held in a trust. A trust is an arrangement whereby trustees take title to property and become responsible for the protection and conservation of such property on behalf of the persons holding the beneficial interest in the property. A trust (other than a grantor trust) generally is treated as a partial conduit for Federal income tax purposes since the trust, although in form a separate taxable entity, is allowed a deduction for amounts distributed to its beneficiaries, which amounts generally are includible in the beneficiaries' income.

A fixed investment trust is a trust used to hold a portfolio of investments for its beneficiaries. Generally such a trust is treated as a trust for tax purposes (and not as an association) if the trustee does not have the power to vary the investments of the trust.[9]

Rules for classifying entities

Corporation or partnership

Under present law, Treasury regulations provide that whether a particular entity is classified as an association taxable as a corporation or as a partnership, trust, or some other entity not taxable as a corporation is determined by taking into account the presence or absence of certain characteristics associated with corporations. These characteristics are (1) associates, (2) an objective to carry on business and divide the gains therefrom, (3) continuity of life, (4) centralization of management, (5) liability for entity debts limited to entity property, and (6) free transferability of interests.[10] These regulations generally are based on the principle stated in *Morrissey v. Commissioner*, 296 U.S. 344 (1935), in which the Supreme Court held that whether an entity is treated as a corporation depends not on the form of its organization, but on whether it more closely resembles a corporate than a noncorporate entity.

Of the characteristics mentioned above, the first two are common both to corporate and partnership enterprises. Consequently, the remaining four factors are determinative of whether the entity is treated as a corporation or as a partnership. Treasury regulations state that the corporate characteristics of an entity must make it more nearly resemble a corporation than a partnership or a trust for the entity to be treated as a corporation.[11] Under this test, the Treasury regulations provide that most limited partnerships formed under the Uniform Limited Partnership Act are not treated

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[8] A deficiency dividend procedure was added to the REIT provisions as part of the Tax Reform Act of 1976 so that a REIT, acting in good faith but failing to satisfy the distribution requirement, could avoid disqualification.

[9] *See* discussion of entity classification, below.

[10] Treas. Reg. Sec. 301.7701-2(a).

[11] *Id.*

as corporations since these entities generally do not possess continuity of life and also may lack limited liability.

Trust or association

Since both corporations and trusts possess centralization of management, continuity of life, free transferability of interests, and limited liability, the determination of whether a particular unincorporated entity is treated as a trust or as an association taxable as a corporation depends on whether there are associates and an objective to carry on business and divide the gains therefrom.[12] Generally, if the purpose of an arrangement is to grant to trustees exclusive responsibility for the protection and conservation of trust property, and the persons with the beneficial interest in the property cannot share in the discharge of that responsibility, there are no associates or an objective to carry on business. Such an arrangement generally will be treated as a trust.[13] On the other hand, if a trust is used for carrying on a profit-making business that ordinarily would be carried on through a business organization such as a corporation or partnership, it will not be treated as a trust.[14] However, a trust that is used to hold income producing assets may be treated as a trust if there is no power under the trust agreement to vary the investment.[15]

In 1984, the Treasury Department issued proposed regulations addressing the treatment of trusts that have more than one class of ownership interest.[16] A trust has one class of ownership if all of the beneficiaries of the trust have undivided interests in all of the trust property. More than one class of ownership may exist where, for example, some beneficiaries are entitled to receive more than their pro rata share of trust distributions in early years and other beneficiaries are entitled to more than their pro rata share in later years.

Under the proposed regulations, an arrangement having more than one class of ownership interest may not be treated as a fixed investment trust. The regulations take the position that because such an arrangement "enables investors to fulfill varying profit-making objectives through the division of rights, and the sharing of risks, in certain assets, the arrangement is considered to have associates and an objective to carry on business and divide the gains therefrom." [17] Thus, if a trust held a portfolio of mortgages or other debt obligations, and interests in the trust assets were divided so that one class of beneficiaries were to receive all principal collected by the trust and a specified rate of interest thereon, until the trust had collected a specified amount of principal, and another class of beneficiaries were to receive all remaining amounts collected by the trust, then such trust would be treated as an association taxable as a corporation under the proposed regulations. The proposed regulations would apply to interests issued after April 27, 1984.

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[12] Treas. Reg. Sec. 1.7701-2(a)(2).
[13] Treas. Reg. Sec. 301.7701-4(a).
[14] Treas. Reg. Sec. 301.7701-4(b).
[15] Treas. Reg. Sec. 301.7701-4(c).
[16] Prop. Treas. Reg. Sec. 301.7701-4(c).
[17] Prop. Treas. Reg. Sec. 301.7701-4(c)(2).

Taxation of Income From Debt Obligations

The original issue discount rules

Treatment of original issue discount as interest

If the borrower receives less in a lending transaction than the amount to be repaid at the loan's maturity, then the difference represents "discount." Discount performs the same function as stated interest, i.e., compensation of the lender for the use of the lender's money.[18] Code sections 1272 through 1275 and section 163(e) (the "OID rules") generally require the holder of a debt instrument issued at a discount to include annually in income a portion of the original issue discount ("OID") on the instrument, and allow the issuer of such an instrument to deduct a corresponding amount, irrespective of the methods of accounting that the holder and the issuer otherwise use.[19]

Definitions

"Original issue discount" is defined as the excess of a debt instrument's "stated redemption price at maturity" over its "issue price." If such excess is less than a certain *de minimis* amount the holder may treat the OID as zero.

"Issue price" is generally (1) in the case of a cash loan, the amount borrowed, (2) in the case of a debt instrument that is issued for property where either the debt instrument or the property is publicly traded,[20] the fair market value of the property, or (3) if neither the debt instrument nor the property exchanged for it is publicly traded, an amount determined using an adequate interest rate.

"Stated redemption price at maturity" includes all amounts payable at maturity excluding any interest based on a fixed rate and payable unconditionally over the life of the debt instrument at fixed intervals no longer than one year.

Operation of the OID rules

The amount of the OID in a debt instrument, if any, is allocated over the life of the instrument through a series of adjustments to the issue price for each "accrual period" (i.e., each six-month or shorter period ending on the calendar day corresponding to the date of the debt instrument's maturity and the date six months prior to the date of maturity). The adjustment to the issue price for each accrual period is determined by multiplying the "adjusted issue price" (i.e., except as may be provided by regulations, the issue price increased by adjustments prior to the beginning of the accrual period) by the instrument's yield to maturity, and then subtracting the interest payable during the accrual period.

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[18] *United States* v. *Midland-Ross Corp.*, 381 U.S. 54 (1965); *see also Commissioner* v. *National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134 (1974).

[19] Prior to 1982, the OID rules applied only to a limited class of obligations. The Tax Equity and Fiscal Responsibility Act of 1982, P.L. 97-248, and the Tax Reform Act of 1984, P.L. 98-369, greatly expanded the number and types of obligations to which the OID rules apply.

[20] Presently, only stock or securities traded on an established securities market are treated as publicly traded. However, section 1503(a)(10) of H.R. 3838 would grant the Treasury Department authority to issue regulations treating as publicly traded other property "of a kind regularly traded on an established market."

The adjustment to the issue price for any accrual period is the amount of OID allocated to that accrual period. These adjustments reflect the amount of the accrued but unpaid interest on the debt instrument in each period. The holder is required to include this amount as interest income and the issuer is permitted a corresponding interest deduction. The holder's basis in the obligation is increased by the amount of OID includible in the holder's income."[21] The application of the OID rules to debt obligations involving multiple payments of principal is somewhat uncertain. Additional uncertainty exists about the application of the rules where the maturity of such payments may be accelerated (e.g., based on prepayments on home mortgages that collateralize the obligation).

Gain or loss on disposition or prepayment

In general, the sale or exchange of a debt obligation that is a capital asset results in the realization of a capital gain or loss to the seller. Under section 1271, amounts received by a holder of a debt obligation, other than one issued by an individual, on retirement of such debt obligation is treated as an amount received in exchange for the debt obligation. Thus, subject to certain exceptions discussed below, if the debt obligation not issued by an individual is a capital asset, its satisfaction, either at or in advance of its maturity, generally results in the realization of a capital gain or loss measured by the difference between the amount realized and the basis of the obligation. Since section 1271 does not apply to obligations issued by individuals, repayment of a debt obligation by an individual (including prepayment) is not treated as a sale or exchange, and thus may not give rise to capital gain or loss.[22]

Capital gain treatment is also unavailable if an obligation has original issue discount and, at the time of original issue, there was an intention to call the obligation before maturity. In such a case, any gain realized on the sale or exchange (including the retirement by the issuer) of the obligation is treated as ordinary income to the extent that the gain does not exceed the amount of original issue discount reduced by the amount of original issue discount that would have been includible in the income of an original holder of the obligation (sec. 1271(a)(2)). There is no authority that directly addresses the application of this provision to corporate debt obligations that are issued with original issue discount and that are called prior to maturity upon the prepayment of mortgages in a pool that collateralizes the debt obligations.

[21] The premise of the OID rules is that, for Federal income tax purposes, an obligation issued at a discount should be treated like an obligation issued at par requiring current payments of interest. Accordingly, the effect of the OID rules is to treat the borrower as having paid semiannually the lender the interest accruing on the outstanding principal balance of the loan, thereby permitting the borrower to deduct as interest expense and requiring the lender to include in income such interest which has accrued but is unpaid. The lender is then deemed to have lent the accrued but unpaid interest back to the borrower, who in subsequent periods is deemed to pay interest on this amount as well as on the principal balance. This concept of accruing interest on unpaid interest is commonly referred to as the "economic accrual" of interest, or interest "compounding."

[22] *See* sec. 1271(b)(1). In addition, obligations issued before July 2, 1982, by an issuer other than a corporation or a government (or political subdivision thereof) do not qualify for capital gains treatment. *See* sec. 1271(b)(2).

The market discount rules

Capital gain treatment on the sale or exchange of a debt obligation also may be denied pursuant to the so-called market discount rules. In general, under the market discount rules (secs. 1276-1278), gain on the disposition of a debt obligation that was issued after July 18, 1984, generally is treated as interest income to the extent of accrued market discount. Market discount is defined as the excess of the stated redemption price of an obligation over its basis immediately after acquisition, (provided that such excess is not less than a certain *de minimis* amount). In the case of a bond that has original issue discount, for purposes of the market discount rules, its stated redemption price is treated as the sum of its issue price and the amount of original issue discount that would have been includible in the income of an original holder.

Accrued market discount on an obligation generally is the amount that bears the same ratio to the market discount on such obligation as the number of days the taxpayer holds the obligation bears to the number of days after the taxpayer acquired the obligation until its maturity. However, the holder may elect to accrue the market discount on an obligation using a constant interest rate.[23] A holder also may elect to include accrued market discount in income annually (sec. 1278(b)). It is unclear under present law how market discount is allocated among principal payments on an obligation where such principal is paid in multiple installments.

If indebtedness is incurred to purchase or carry obligations that have market discount, interest on such indebtedness in excess of the amount of interest includible in income with respect to such obligation is deductible only to the extent that such interest exceeds the market discount allocable to the taxable year (sec. 1277). Any interest expense disallowed under this provision is allowable as a deduction in the year that the obligation is disposed of. Nevertheless, this limitation on interest deductions is not imposed if the holder elects to include market discount in income currently.

The coupon stripping rules

The separation of ownership of the right to receive any payment of principal or interest on a debt obligation generally results in the application of the "coupon stripping rules" (sec. 1286). Under these rules, the holder of a debt obligation who disposes of the right to receive certain payments on the obligation (other than a pro rata share of all payments), must allocate (on the basis of fair market value) his basis in the obligation between the portion of the debt obligation that is disposed of and the portion retained for purposes of recognizing gain or loss.

Following such a disposition, for purposes of the treatment of the holder, the retained portion is treated as a debt obligation having original issue discount equal to the excess of the amount that will be received upon payment of amounts due at maturity of such retained portion over the amount of basis allocated thereto. Similarly, a purchaser of the disposed of portion of the debt obligation is

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[23] The constant interest rate method results in smaller amounts being treated as accrued market discount in the earlier years.

treated as having purchased a debt obligation having original issue discount equal to the excess of the amount payable upon maturity of such portion over the amount paid therefor. The original issue discount rules then govern the amount that the respective holders must include in income annually.

Withholding on interest paid to foreign taxpayers

In general, a 30-percent withholding tax is imposed on interest paid to foreign taxpayers (secs. 871, 881, 1441, and 1442).[24] However, the withholding tax is not imposed on interest paid on certain obligations issued after July 18, 1984 (secs. 871(h) and 882(c)). Although obligations issued by individuals generally are not eligible for the exception,[25] most mortgage related securities issued after July 18, 1984 are eligible for the exception.[26] This is true even if the mortgage related security is in the form of a participation certificate in a grantor trust, in which case, the holder is for substantive tax purposes treated as holding a proportionate share of the underlying mortgages. In such a case, however, the exemption from the withholding tax is applied only to the extent that the underlying mortgages were issued after July 18, 1984.[27]

Background and Issues

Participation certificates

Mortgage related and other asset backed securities frequently are issued in the form of "participation certificates" in a pool of mortgages or other debt obligations held by a grantor trust. Holders of participation certificates are treated as the owners of proportionate shares of the trust's assets, and are required to include in income proportionate shares of the trust's income. Holders also are entitled to deduct proportionate shares of the trust's expenses.[28]

The use of grantor trusts has certain limitations, however. First, the trustees are not permitted to actively manage the trust's assets and have only the most circumscribed reinvestment power.[29] Second, the proposed regulations effectively prevent the issuance of more than one class of beneficial interest in the trust because those regulations would require the imposition of a corporate tax on the trust's income.

Because grantor trusts may have only one class of beneficiaries, all holders of participation certificates are subject to the risk of prepayment of all or a portion of their investment, depending on the extent of prepayments of the obligations held by the trust. This inability to cater to the differing investment objectives of various investors has been a source of market dissatisfaction with these instruments.

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[24] A lower rate of tax may be imposed pursuant to a treaty.
[25] Temp. Treas. Reg. sec. 35a.9999-5(a) (Q & A 1).
[26] Temp. Treas. Reg. sec. 35a.9999-5(d) (Q & A 20).
[27] *Id.*
[28] *See* Rev. Rul. 84-10, 1984-1 C.B. 155; Rev. Rul. 77-349, 1977-2 C.B. 20; Rev. Rul. 71-399, 1971-2 C.B. 433, *amplified by* Rev. Rul. 81-203, 1981-2 C.B. 137, Rev. Rul. 80-96, 1980-1 C.B. 317, Rev. Rul. 74-300, 1974-2 C.B. 169, Rev. Rul. 74-221, 1974-1 C.B. 365, and Rev. Rul. 72-376, 1972-2 C.B. 647; Rev. Rul. 70-544, 1970-2 C.B. 6 and Rev. Rul. 70-545, 1970-2 C.B. 7, *both modified by* Rev. Rul. 74-169, 1974-1 C.B. 147.
[29] *See* Rev. Rul 75-192, 1975-1 C.B. 384.

'ollateralized mortgage obligations

In addition to participation certificates in grantor trusts, many ıortgage related and other asset backed securities are issued in he form of debt obligations of highly leveraged corporations that old a portfolio of debt obligations, most frequently real property ıortgages. These corporate debt obligations frequently are issued ı differing maturities. The cash flow of the underlying mortgages ; used to service the debt obligations, and the income of the corpoation arising from the mortgages that it holds may be largely or ompletely offset by interest on the corporation's debt. To the xtent such offsetting occurs, the income from the underlying ıortgages is effectively taxed only to the debtholders. Arrangeıents of this sort are commonly known as "collateralized mortgage bligations" or "CMOs."

Although the ability to issue obligations of differing maturities is n advantage for this form of mortgage backed security, there also re several disadvantages. First, a corporate debt obligation and ıe income from such debt obligation are not among the types of ualifying assets or income for purposes of whether an entity qualies as a REIT, even if the obligation is secured by real property ıortgages.[30] In addition, such obligations do not qualify as "loans ecured by an interest in real property" for purposes of a savings nd loan association's ability to compute its bad debt deductions nder the percentage of taxable income method.[31]

Second, where a corporation is formed for the sole purpose of olding debt obligations and issuing CMOs, in order to minimize ıe risk that the obligations would be treated as equity, (the distriutions with respect to which are not deductible unless, for examle, the corporation qualifies as a REIT), rather than as debt, the orporation must have some at least some minimal amount of capialization. This capital, which presumably must be supplied by the ransferor of the mortgages, in effect increases the cost of issuing MOs by subjecting such additional capital to a corporate layer of ax.

Third, in order for the corporate issuer to be treated as the wner of the underlying debt obligations, rather than as a mere ustee for the debtholders, the corporation must have some reinestment risk with respect to the underlying obligations, i.e., the ebt service may not be too closely matched to the cash flow generted by the collateral. Thus, the corporate issuer may not complete- transfer all reinvestment risk to the CMO holders.

Fourth, the corporate issuer must pay income tax on the differnce between the interest income on the issuer's assets and the inerest on the CMOs.[32]

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[30] *See* sec. 856(c).
[31] *See* secs. 593 and 7701(a)(19).
[32] Such difference may arise, for example, where the CMOs are issued with different yields ıd different maturities, essentially because deductions with respect to higher yield, longer maırity debt tend to be weighted toward the later years relative to lower yield, shorter maturity ebt.

Other formats for issuing mortgagerelated securities

Other vehicles for investing in mortgages also suffer from certai disadvantages. While it is possible to use an S corporation to issu debt, under present law, only individuals can hold shares of an corporation, and the maximum number of shareholders is limite to 35. REITs must have at least 100 shareholders. The ability of in stitutional investors to hold interests in limited partnerships ma be limited under state law. Fixed investment trusts may be unat tractive with respect to ownership by REITs and savings and loa associations because an interest in the trust may not be treated a a qualifying interest in real property or real property loans.

Issues

The stated purpose of the bills (S. 1959 and S. 1978) is to provid an indirect investment vehicle that does not contain the variou disadvantages discussed above. However, these proposals raise number of issues:

First, is it appropriate to create another type of conduit entit under the tax laws for investment on mortgages or other obliga tions? Moreover, should conduit treatment be provided for a entity that can issue several classes of securities?

Second, should only home mortgages qualify for any specia treatment, or should any other debt obligations qualify as well?

Third, how should the OID and market discount rules be applie to divided interests in debt obligations?

Fourth, under what circumstances should foreign investors be e igible for the exemption from withholding tax?

Fifth, should any newly created conduit treatment apply with re spect to interests created in all outstanding obligations or onl newly issued obligations.

Sixth, should any or all of the interests in a newly created con duit entity be treated as real estate assets for purpose of REI qualification, or as real property loans for the purpose of qualifica tion for percentage bad debt deductions.

Explanation of the Bills

1. S. 1959 (Senator Chafee)

Overview

The Secondary Market Tax Amendments of 1986 ("SECTA"), S 1959, introduced by Senator Chafee, would create a new form c mulitple class mortgage related security, known as a "collatera lized mortgage security" or "CMS." Holders of the CMS would b treated as beneficial owners of the underlying mortgages. The bi would provide rules prescribing the income tax treatment of tax payers who exchange mortgages for CMSs, the treatment of tax payers holding CMSs, and the treatment of the disposition c CMSs. Among these rules are clarifications of the application c the OID rules to obligations the timing of whose maturities is con tingent upon the timing of payments on the underlying collatera In addition, certain new information reporting requirements woul be imposed on issuers of CMSs.

ssuance of a CMS

Under the bill, a CMS may be issued in the form of an ownership nterest in a corporation, association, trust, or partnership holding 'qualified obligations," or as a debt obligation issued by any of the bove. Regardless of the form, the issuance of a CMS generally vould be treated as a sale of the collateral securing the CMS to the olders of the CMS. Thus, the initial transferor of the qualified obigations and the the entity that holds such obligations and issues hat CMSs would be treated as entirely separate entities, i.e., CMSs ssued in the form of debt would not be treated as debt of the transeror of the qualified obligations and, except to the extent that the ransferor holds CMSs, the income generated by the underlying colateral would not treated as income of the transferor.

A CMS could represent either a "regular" or "residual" interest n the underlying collateral. A regular interest would entitle the older to receive specified principal payments (or analagous mounts in the case of CMSs not issued in the form of debt), the iming of which principal payments would be contingent upon the iming of receipt of principal payments on the underlying collater-l and the amount of income from temporary reinvestments of ortfolio cash flows. A residual interest would entitle the holder to eceive amounts that are contingent with respect to both timing nd amount upon the extent of prepayments on qualified obligaions, the amount of income from temporary reinvestment of portolio cash flows, and the amount of contingent payments received n qualified obligations. A regular interest, unlike a residual interst, could provide for the payment of interest on the outstanding rincipal balance of the CMS.

ligible collateral for a CMS

In general, in order to qualify as a CMS under the bill, a security nust be collateralized either by "qualified obligations" or "permited investments." Qualified investments would include real propery mortgage loans, interests in other CMSs, participation certifiates representing beneficial interests in such obligations, guaraneed investment contracts, and property acquired pursuant to the lefault of or the substitution for a defective qualified obligation. ermitted investments generally would include cash and cash tems that either were part of the initial collateral of the CMS or vere subsequently acquired under certain circumstances, and the emporary reinvestment of cash flows.

ransfers of qualified obligations

In general, the transfer of qualified obligations to a CMS issuer i.e., the entity that holds the collateral) in exchange for cash or ther property would result in recognition of gain or loss to the ransferor. If qualified obligations were transfered in exchange for egular interests, no loss would be recognized, but gain generally vould be recognized, except to the extent provided in regulations. f qualified obligations are exchanged for residual interests, no gain r loss would be recognized.

If qualified obligations are transfered to a CMS issuer in exhange for regular and residual interests, or either or both such interests along with cash, the basis of the qualified obligations transferred would be allocated in proportion to the fair market value of the interests (and cash, if any) received. The transferor would be permitted to elect to treat the fair market value of residual interests as zero in certain circumstances.

Treatment of holders of CMSs

Under the bill, holders of regular interests generally would be taxed as if their regular interest were a debt obligation to which the rules of taxation generally applicable to debt obligations apply. The bill, however, would provide rules clarifying the application of the OID rules to debt instruments that, as may be the case with CMSs, have a maturity that is initially fixed, but that is accelerated based on prepayments on the underlying collateral. In general, the clarified OID rules would require OID for an accrual period to be calculated and included in the holder's income based on the increase in the present value of the obligation, taking into account the amount of acceleration of the obligation's maturity attributable to prepayments during the period as well as payments received on the CMS during the period.

Holders of residual interests generally would include amounts in income when paid or credited. The holder's basis, if any, would be recovered as a deduction on a straight line basis over the estimated duration of the residual. Any gain that was not recognized by the transferor of a qualified obligation on the transfer of such obligation to the issuer in exchange for a residual interest would be taken into income on a straight line basis over the estimated duration of the residual. Regulatory authority would be granted to the Treasury Department to issue regulations that would treat residual interests more like debt obligations in certain limited circumstances.

The bill also would provide for the acceleration of the recognition of income to holders in certain circumstances. Where the cumulative amount of income recognized by all holders of regular and residual interests (under the normal rules for the recognition of interest income, the OID rules as prescribed by the bill, and the special rules for residual interests) is less than the cumulative amount of income that would have been recognized if the CMS collateral were held by a single taxable entity, then the shortfall would be allocated to the holders of regular and residual interests in accordance with a formula prescribed by the bill. Any additional income so allocated would reduce the amount of income that must be recognized in later years.

Outside premium and discount

"Outside premium" on a CMS generally would be the excess of the holder's cost (or such other amount that ordinarily would be the holder's basis immediately after the acquisition) for a CMS over the adjusted issue price of the CMS. Outside premium also could arise where loss is not recognized on the transfer of obligations to the holding entity; the outside premium would equal the unrecognized loss.

"Outside discount" on a CMS generally would be the excess of the adjusted issue price of the CMS over the holder's cost for the

MS (or such other amount that ordinarily would be the holder's isis immediately after the acquisition). Like outside premium, itside discount also could arise in a case where gain is not recogzed on the transfer of obligations to the holding entity.

Outside premium on a regular interest, to the extent it does not ceed the amount of OID with respect to such interest, would be nortized over the duration of the interest in the same proportion at the amount of OID includible for each accrual period bears to e total amount of OID. Any outside premium in excess of the nount of OID would be recovered ratably in the same proportion at the amount of principal (or similar amounts) received that ar bears to the total amount of principal.

Outside discount on a regular interest would be treated as arket discount. Under the bill, such discount would be recovered the proportion that the amount of principal (or similar amounts) ceived bears to the total amount of principal. Such inclusions uld be treated as capital gains to the extent that the underlying ligations would not be subject to the market discount rules, i.e., the extent that such obligations were issued before July 19, 1984. however, at least 85 percent of the the underlying obligations ere subject to the market discount rules, or at least 85 percent ere not, then all of the obligations would be so treated.

Outside premium or discount on residual interests would be revered ratably over the estimated duration of the residual.

sposition of a CMS

In general, the disposition of a CMS would be treated like the sposition of a debt obligation. The market discount rules would applied to determine the character of any gain recognized in the me manner as in determining the character of any recovery of tside discount upon payments of principal.

her provisions

The bill would provide special rules relating to the accounting r expenses of issuance of CMSs, as well as ongoing expenses of e CMS issuer. In addition, the bill would impose a 100 percent x on income from prohibited transactions, including gains from e sale or exchange of qualified obligations (with certain excepons), and income relating to assets that are not permissible CMS llateral. The bill also would provide special rules for the sale of l of the assets of a CMS issuer and the distribution of the proeds to the CMS holders.

The bill also would expand the interest and OID reporting reiirements of present law and would apply such expanded provims to CMSs as well as any other forms of mortgage related secuties or debt obligations. Under the bill, reporting would be reiired with respect to interests held by corporations, registered serities or commodities dealers, RICs, REITs, and certain common ust funds. The reporting requirement also would include certain lditional information relating to the taxation of any multiple ass interests. CMSs would file annual information returns and ould be subject to entity level audit procedures similar to those oplicable to partnerships.

Effective dates

In general, the provisions of the bill would be effective after th date of enactment. An election would be provided for the applica tion of the provisions of the bill after December 17, 1985 (the dat of introduction).

2. S. 1978 (Senators Cranston, D'Amato, Dixon, and Dodd)

Overview

S. 1978 would amend the grantor trust provisions of the Cod and authorize the issuance of multiple class pass-through securitie by grantor trusts. Under the bill, qualifying pass-through securitie would be treated as representing ownership interests in the assets the payments with respect to which are passed through to the hold ers of the security.

Pass-through securities

In general, under the bill, a "pass-through security" would be security that represents the holder's right to receive certain pay ments on identified qualifying "financial instruments," as well a certain other rights. Financial instrument also would include an retained beneficial interest in any financial instrument subject t such an arrangement. The interests represented by such pass through securities could be divided into multiple classes. To qualif for the pass-through treatment, the issuance of the pass-through se curity otherwise must be treated as a disposition of the underlyin financial instruments. Thus, the provisions of the bill would nc apply to securities that otherwise would be treated as a debt obliga tion of the owner of the underlying financial instruments.

Where certain requirements are met, the arrangement pursuan to which the financial instruments are held would be treated as grantor trust, and the holder of a pass-through security would b treated as having beneficial ownership in the underlying financia instruments. For example, a pass-through security would be treat ed as a qualifying asset for purposes of determining whether a entity meets the asset test applicable for qualification as a REIT t the extent that the financial instruments themselves would b qualifying assets.

Financial instruments

Under the bill, the term "financial instrument" generally woul include most debt obligations, as well as accounts receivable, leas receivables, and the proceeds of any financial instrument an amounts earned on the temporary reinvestment of such proceeds The term also would include an interest in a pass-through securit representing an interest in such financial instruments.

Limitations

The provision of the bill would apply only if the the interests i the financial instruments were established and fixed (except wit respect to attributes inherent in the underlying instruments) pur suant to the terms of the initial issuance of the pass-through secu rity. In addition, the underlying financial instruments would hav o be identified prior to the first payment on any of the pass-hrough securities, and substitution would be permitted within a imited period only for defective instruments.

Effective date

The provisions of the bill would apply to pass-through securities ssued after April 27, 1984.

Previous Legislative Proposal

In 1983, Senators Garn and Tower introduced a bill (S. 1822, 98th Cong.) that would have created a new conduit entity for holding ome mortgages, known as a "Trust For Investments in Mort-ages" or "TIM." The bill provided detailed rules for the treatment f most aspects of transactions involving the creation of the TIM, he taxation of continuing holders of TIM shares, dispositions of TIM shares, and dissolution of the TIM. The bill would have per-nitted a TIM to issue shares in a multiple class arrangement.

B. Tax Treatment of Deductions and Credits for Expenditures in Environmental Zones

S. 1839 (Senator Chafee)

Present Law

Overview

Various tax rules provide incentives for certain types of economic development activities. These include accelerated cost recovery provisions; tax credits for specified activities; and numerous other provisions. In general, these rules (and other tax rules) apply regardless of geographic location within the United States.

Cost recovery rules

Accelerated cost recovery system (ACRS)

The Economic Recovery Tax Act of 1981 ("ERTA") enacted the Accelerated Cost Recovery System ("ACRS") for tangible depreciable property placed in service after 1980. Under ACRS, the cost or other basis of eligible property (without reduction for salvage value) is recovered using an accelerated method of depreciation over a predetermined recovery period that is generally shorter than the asset's useful life (sec. 168). (Under pre-1981 law, an asset's cost (less salvage value) was recovered over its estimated useful life (sec. 167).) The pre-1981 rules remain in effect for property placed in service by a taxpayer before 1981, and for certain property not eligible for ACRS. "Foreign use" property (i.e., property used predominantly outside the United States) is one type of property not qualifying for ACRS.

Under ACRS, the allowable depreciation deduction in each recovery year is determined by applying a statutory percentage to the property's original cost, adjusted for the investment tax credit claimed (sec. 168(b)(1)). The statutory percentages for personal property are based on the 150-percent declining balance method for the early recovery years, switching to the straight-line method. Alternatively, taxpayers can elect to use the straight-line method over the applicable ACRS recovery period or a longer recovery period with respect to one or more classes of property placed in service during any taxable year. The statutory percentages for real property are based on the 175-percent declining balance method (200-percent for low-income housing), switching to the straight-line method. For real property placed in service after May 8, 1985, the cost of real property is recovered over a 19-year recovery period (15 years for low-income housing), although longer recovery periods may be elected.

A taxpayer (other than a trust or estate) can elect to deduct the cost of up to $5,000 of qualifying personal property in the year the roperty is placed in service, in lieu of recovering the cost under CRS (sec. 179). In general, qualifying property must be acquired purchase for use in a trade or business, and must be eligible for e investment tax credit, although no investment credit is allowed r the portion of the cost expensed under this rule. The $5,000 nit is scheduled to increase to $7,500 for taxable years beginning 1988 and 1989, and to $10,000 for years beginning after 1989.

Provisions relating to natural resources

Intangible drilling and development costs.—Capital expenditures curred by an operator to develop an oil, gas, or geothermal propty are of two general types: (1) intangible drilling and developent costs, and (2) depreciable costs.

Under present law, intangible drilling and development costs IDCs") either may be deducted in the year paid or incurred ("exnsed") or else may be capitalized and recovered through deplen or depreciation deductions (as appropriate), at the election of e operator. (In the case of integrated producers, 80 percent of Cs may be expensed and the remainder amortized over 36 onths.) In general, IDCs include drilling-related expenditures g., for labor, fuel, repairs, hauling, supplies, etc.) which are neier for the purchase of tangible property nor part of the acquisin price of an interest in the property.

Depreciable drilling costs are amounts paid or accrued during e development of a property to acquire tangible property (e.g., ols, pipe, casing, boilers, etc.) which ordinarily are considered to ive a salvage value. These expenditures must be capitalized and preciated in the same manner as ordinary items of equipment ee discussion of ACRS above), and they are treated in the same anner for both independent and integrated producers.

Percentage depletion for oil and gas (and geothermal) propers.—The costs of acquiring a lease or other interest in an oil or is (or geothermal) property, together with certain other costs, are covered through depletion deductions. These deductions are dermined using the cost or—if available—the percentage depletion ethod, whichever results in a higher deduction.

Under cost depletion, the taxpayer deducts that portion of the ljusted basis of the property which is equal to the ratio of units roduced and sold from that property during the taxable year to ie number of units that are estimated to be recoverable from the roperty at the beginning of the taxable year. The amount recoved under cost depletion cannot exceed the taxpayer's basis in the roperty.

Under percentage depletion, 15 percent of the taxpayer's gross icome from an oil- or gas-producing property is allowed as a deuction in each taxable year. The amount deducted may not exceed) percent of the net income from that property in that year (the net income limitation"). Additionally, the deduction for all oil and as properties may not exceed 65 percent of the taxpayer's overall ixable income. Because percentage depletion is computed without egard to the taxpayer's basis in a property, it may result in evenial recovery of an amount greater than the taxpayer's basis in the roperty.

Since 1975, percentage depletion has been limited to 1,000 barrel per day of oil production (or an equivalent amount of natural ga production) by independent producers. This rule, and the 65-per cent limitation above, do not apply to geothermal deposits.

Hard minerals.—Expensing of hard mineral exploration and de velopment costs may be elected under the Code (secs. 616 and 617 although expensed exploration costs are subject to recapture whe a mine reaches the producing stage. Percentage depletion of har mineral deposits also is provided, at rates ranging from 5 to 22 pe cent.

Soil and water conservation and land clearing expenses

A taxpayer engaged in the business of farming is permitted t deduct currently (i.e., expense) certain expenditures for the purpos of soil or water conservation, or the prevention of erosion, with re spect to farmland. The amount deducted may not exceed 25 percen of the taxpayer's gross income from farming during the taxabl year. Farmers may also expense amounts paid or incurred for th clearing of farmland, up to the lesser of $5,000 or 25 percent of ta able farming income.

Tax credits

Investment tax credit

A credit against income tax liability is allowed for up to 10 pe cent of a taxpayer's investment in certain tangible depreciabl property (generally, not including buildings or their structura components) (sec. 46). The amount of this "regular" investmen credit is based on the ACRS recovery class to which the property assigned. The credit is generally claimed for the taxable year i which qualifying property is placed in service.

The amount of income tax liability that can be reduced by inves ment tax credits in any year is limited to $25,000 plus 85 percent o the liability in excess of $25,000. Unused credits for a taxable yea may be carried back to each of the three preceding taxable year and then carried forward to each of the 15 following taxable year

Special energy investment tax credits, at rates of up to 15 pe cent, have been provided for investments in various types of alte native energy property (including solar, wind, and geotherma property); however, these credits generally expired on (or prior t December 31, 1985. A further special credit is allowed for certai rehabilitation expenditures.

Alternative fuels production credit

A tax credit is provided for the domestic production and sale o oil, gas, and other fuels from certain nonconventional sources (se 29). The credit is scheduled to expire for facilities placed in servic or wells drilled, on or after January 1, 1990.

The credit equals $3 for each barrel-of-oil-equivalent of energ produced, adjusted (except for certain natural gas) for post-1979 i flation. The credit is phased out as the annual average wellhea price of uncontrolled domestic oil rises from $23.50 to $29.50 barrel, similarly adjusted for inflation ($32.10 and $40.30 in 198 rices). The credit thus functions essentially as a minimum price ipport for fuel produced from nonconventional sources.

apital gain rules applicable to timber, coal, and domestic iron ore

The owner of timber (or a contract right to cut timber) may elect treat the cutting of timber as a sale or exchange qualifying for ng-term capital gain treatment, even though the timber is sold or sed in the taxpayer's trade or business (sec. 631(a)). (Capital gains re taxed at a maximum rate of 20 percent for individuals and 28 ercent for corporations.) This provision generally requires that the mber (or contract right) be held for more than six months prior to itting.

Royalty income with respect to timber, coal, and domestic iron re, also qualifies for capital gain treatment, subject to a similar 6-ionth requirement. In the case of coal and domestic iron ore royal-es, if capital gain treatment applies, the royalty owner may not tilize percentage depletion with respect to the mineral disposed of.

idustrial development bonds (IDBs)

Interest on State and local government obligations generally is xempt from Federal income tax (Code sec. 103).

Interest on industrial development bonds (IDBs) is tax-exempt ily if the IDBs are issued for certain specified purposes. Industrial evelopment bonds are obligations issued as part of an issue 25 per-ent or more of the proceeds of which is to be used in any trade or usiness carried on by a nonexempt person and the payment of rincipal or interest on which is derived from, or secured by, ioney or property used in a trade or business. "Nonexempt per-ons" are persons other than State or local governments or tax-xempt charitable, religious, educational, etc., organizations (de-cribed in Code sec. 501(c)(3)).

One of the exceptions under which interest on IDBs is tax-xempt is when the proceeds of the bonds are used to finance cer-iin exempt activities. Under this exception, interest on IDBs is ix-exempt if the bonds are used to finance the following activities:) projects for multi-family residential rental property; (2) sports icilities; (3) convention or trade show facilities; (4) airports, docks, harves, mass commuting facilities, or parking facilities; (5) sewage nd solid waste facilities, or facilities for the local furnishing of lectricity or gas; (6) air or water pollution control facilities; (7) fa-lities for the furnishing of water; (8) qualified hydroelectric gener-ting facilities; (9) qualified mass commuting vehicles; or (10) local istrict heating or cooling facilities. In addition, interest on IDBs sed to acquire or develop land as the site for an industrial park is xempt from tax.

Interest on "small issue" IDBs used for the acquisition, construc-on, or improvement of land or depreciable property also is gener-lly tax-exempt. This exception applies to issues having an aggre-ate authorized face amount (including certain outstanding prior ssues) of $1 million or less. Alternatively, the aggregate face mount of the issue, together with the aggregate amount of related apital expenditures during a 6-year period, may not exceed $10 iillion.

Since 1984, most IDBs (together with student loan bonds) have been subject to statewide volume limitations.

At-risk rules

Present law (Code sec. 465) provides an at-risk limitation on losses from business and income-producing activities, applicable to individuals (including members of a partnership), S corporations and certain closely held corporations. In general, the at-risk rules are designed to prevent a taxpayer from deducting losses in excess of the taxpayer's actual economic investment (i.e., the amoun which the taxpayer has "at risk") in the activity.

An exception from the at-risk rules is provided for active busi nesses conducted by a closely held corporation. The at-risk rules also do not apply to real estate investments and certain corporat leasing transactions.

Issues

The bill would restrict tax incentives for certain types of invest ment in designated environmentally sensitive areas. In particular the intent of the bill is to limit the apparently anomalous situation in which generally applicable tax incentives encourage develop ment in areas where development is discouraged or regulated under other Federal laws.[33] These include tax incentives for farm ing, energy production, and investment in depreciable property.

The definition of "environmental zones" raises several issues The bill would restrict incentives for all activities in broad geo graphic areas designated in (or pursuant to) environmental stat utes. The issue arises whether distinctions should be allowed be tween activities which may be relatively more harmful than other to a particular area. Although this could distinguish among par ticular projects according to their potential environmental harm this would require a costly case-by-case evaluation of the environ mental impacts of specific privately financed projects. Further, re lying on environmental statutes for designating geographic area may also leave tax determinations dependent on legislation (an regulations) originally drafted for other purposes. On the othe hand, this may be preferable to the existence of potential conflict between the tax laws and environmental policy.

The bill raises several administrative issues. For example, i would be necessary to determine the proper allocation of an invest ment that is located partially inside and partially outside a desig nated environmental zone. A similar issue arises with respect t property that moves in and out of these zones. Another administra tive issue involves future designation of additional areas as envi ronmentally sensitive (such as, for example, by expansion of th National Parks system), and the effect of that designation on cur rent or anticipated expenditures in these zones.

[33] *See*, *131 Cong. Rec.* S15118-15119 (November 7, 1985) (statement of Sen. Chafee).

Explanation of the Bill

general

'he bill would modify the tax treatment of various items with pect to property located in environmental zones. In general, se modifications are intended to eliminate tax incentives for de- opment in these areas. "Environmental zones" would be defined reference to specified Federal statutes.

finition of "environmental zone"

'or purposes of the bill, an "environmental zone" would include area (or portion thereof) located within the boundaries of an a:

l) which is designated by the Secretary of the Interior as a criti- habitat under the Endangered Species Act (16 U.S.C. sec. 1531 *eq.*);

2) which is authorized by an Act of Congress to be included, or ignated by the Secretary of the Interior or the Secretary of Ag- ılture for inclusion, within the National Wildlife Refuge tem, the National Park System, or the National Forest System, which has not yet actually become subject to the laws govern- management of such systems;

3) which is a unit of the Coastal Barrier Resources System;

4) which has been designated by the Secretary of the Interior as ational natural landmark under the Historic Sites, Buildings, l Antiquities Act (16 U.S.C. sec. 461 *et seq.*); or

5) which has been authorized by an Act of Congress for study as otential unit of the Wild and Scenic Rivers System, unless such a has been found by the Secretary of the Interior, after comple- ı of such study, not to qualify for designation under the Wild l Scenic Rivers Act (16 U.S.C. sec. 1271 *et seq.*).

st recovery for environmental zone property

Depreciation and amortization

Jnder the bill, amounts paid or incurred for property used pre- ninantly in an environmental zone would be recovered in the ne manner as expenditures for property used predominantly out- e the United States (sec. 168(f)). Thus, expenditures for personal perty would be recovered using the double-declining balance thod over ADR (i.e., pre-1981) class lives (12 years, for property ving no such class life), switching to the straight-line method in later years. Expenditures for real property would be recovered r a 35-year period using the 150-percent declining balance thod, switching to the straight-line method. (Taxpayers also ıld elect straight-line recovery for real or personal property over above or certain longer periods.) These recovery methods would e the place of the accelerated methods (ACRS) generally avail- e currently for domestic property.

The election to expense up to $5,000 of certain depreciable prop- y would be repealed for property used predominantly in an envi- ımental zone.

Expenses relating to natural resources

Percentage depletion would be denied for oil and gas well mines, and geothermal deposits located in an environmental zon These properties would be limited to utilizing cost depletion. Add tionally, expensing of intangible drilling and development cos (under sec. 263(c)) and tertiary injectants (under sec. 193) would b eliminated with respect to environmental zone properties.

Soil and water conservation and land clearing expenditures

The provisions allowing farmers to expense certain soil an water conservation expenditures, and certain land clearing expen itures, would not apply with respect to land located in an enviro mental zone.

Effective dates for cost recovery provisions

These amendments generally would apply to amounts paid or i curred after June 30, 1986, in taxable years ending after that dat The amendments with respect to depreciation and amortization (i cluding the denial of the option to expense certain depreciab property) would not apply to property (1) the construction or reco struction of which began before November 7, 1985, (the date th bill was introduced) or (2) which was acquired pursuant to a bin ing contract between the taxpayer and an unrelated person, whic contract was in effect on November 7, 1985, and at all times ther after. Other provisions would not apply to any amounts paid or i curred before July 1, 1987, pursuant to a binding contract with a unrelated person which was in effect on November 7, 1985, and a all times thereafter.

Disallowance of tax credits for expenditures in an environment zone

The bill would repeal the investment tax credit with respect any property used predominantly within an environmental zon This amendment would apply generally to periods after June 3 1986;[34] however, an investment tax credit would remain availab with respect to property qualifying for present law depreciatio treatment under the bill (as described above).

The nonconventional fuels production credit (sec. 29) also woul not apply with respect to sales of qualified fuels produced in (from any property extracted or removed from) an environment zone. This amendment would apply to sales after June 30, 198 with an exception for binding contracts in effect between the ta payer and an unrelated person on November 7, 1985, and at a times thereafter.

Capital gain treatment for timber, coal, and iron ore

Under the bill, the special capital gain rules with respect timber, coal, and domestic iron ore (sec. 631) would not apply any timber located in, or any coal or iron ore extracted from, a environmental zone. This provision would apply to sales or e

[34] This effective date would be applied using the general Code principles for investment t credit transitions (sec. 48(m)).

ıanges taking place after June 30, 1986, unless made pursuant to binding contract between the taxpayer and an unrelated person, ıich is in effect on November 7, 1985, and at all times thereafter.

dustrial development bonds

No tax-exempt industrial development bonds (IDBs) could be ṣued to finance any facility located within an environmental ne, effective for obligations issued after June 30, 1986. Transition- relief would be provided for obligations issued pursuant to an in- ıcement resolution adopted on or before November 7, 1985.

t-risk rules

The at-risk rules (sec. 465) would be extended to the holding of al property (as well as other investments) in an environmental ne. The at-risk exceptions for certain equipment leasing by close- held corporations and for active closely held businesses also ould not apply to activities conducted within a zone. These anges would apply for losses occurring after June 30, 1986.

rant of regulatory authority

The bill would specifically authorize the Secretary of the Treas- y to prescribe such regulations as may be necessary or appropri- e to carry out the provisions of the bill. These may include rules vering situations in which the computation period for any deduc- on includes a period during which an area is designated as an en- ronmental zone and a period during which it is not.

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