

[COMMITTEE PRINT]

TAX REDUCTION AND REFORM PROPOSALS

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**TAX SHELTERS
AND MINIMUM TAX**

PREPARED FOR THE
COMMITTEE ON WAYS AND MEANS
BY THE STAFF OF THE
JOINT COMMITTEE ON TAXATION



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I. INTRODUCTION

This pamphlet is the second in a series prepared by the staff of the Joint Committee on Taxation for use by the Committee on Ways and Means in its consideration of the Administration's tax reduction and reform proposals. A previous staff pamphlet (dated January 27, 1978) provided an overall summary of those proposals.

This pamphlet discusses in detail the Administration proposals relating to tax shelters and the minimum tax. The tax shelter proposals described in this pamphlet are those dealing with: (1) the at-risk rule; (2) classification of limited partnerships; (3) audits of partnerships; (4) deferred annuities; and (5) accrual accounting for farming corporations. The Administration also grouped its proposals regarding real estate depreciation with its tax shelter proposals. The staff description and discussion of the proposals regarding real estate depreciation is in a separate pamphlet. (See Staff Pamphlet No. 3).

For each of the specific Administration proposals, this pamphlet includes an explanation of present law, background information on the topic (including legislative history), a description of the Administration proposal, a description of alternative proposals by Members of the Ways and Means Committee, a discussion of the issues involved in the various proposals, and the estimated revenue impact of the Administration proposal.

A brief summary of the Administration proposals and of the related present law precedes the detailed description.



II. SUMMARY OF ADMINISTRATIVE PROPOSALS

A. TAX SHELTER PROPOSALS

1. At-Risk Limitation

Present Law

Two separate "at risk" rules were enacted by the Tax Reform Act of 1976 to prevent certain tax shelter abuses. One rule ("the specific activity at risk rule") applies to all taxpayers (except corporations which are neither subchapter S corporations nor personal holding companies) who engage in any of four specified activities: producing and distributing motion pictures, farming, equipment leasing, and exploring for oil and gas. The other rule ("the partnership at risk rule") applies to all partnership activities other than real estate and those to which the specific activity at risk rule applies. These two rules generally limit the amount of losses an investor can deduct from activities which are covered by these rules.

Administrative Proposal

The Administration proposal would revise the at risk rules by expanding the specific activity at risk rule to apply to all activities other than real estate. The partnership at risk rule would then be repealed as redundant. The revised at risk rule would apply to corporations in which 5 or fewer individuals own more than 50 percent of the stock, as well as to all subchapter S corporations and personal holding companies. In the case of an affiliated group of corporations, the revised at risk rule would apply to all corporations in the group if it applied to the common parent. Finally, the revised at risk rule would require taxpayers to recapture deductions previously claimed where amounts originally placed at risk are withdrawn.

2. Classification of Limited Partnerships

Present Law

Under present law, the terms "partnership" and "corporation" are rather generally defined. The existing regulations provide that an organization formed as a partnership under local law will not be classified as a corporation for tax purposes unless it has more corporate characteristics than noncorporate ones. Under this "preponderance" test, organizations formed as partnerships under the Uniform Limited Partnership Act are nearly always classified as partnerships for tax purposes.

Under present law, partnerships are not treated as taxable entities, and each partner is taxed on his share of the partnership income and allowed to deduct his share of any partnership losses. On the other hand, corporations (except for certain electing corporations with a limited number of shareholders—subchapter S corporations) are taxed as separate entities, with no passthrough of corporate income or losses to the shareholders.

Administration Proposal

The Administration proposal would treat a limited partnership formed after the effective date as a corporation for tax purposes if the partnership has more than 15 limited partners.

Generally, the effective date would be the date of enactment. However, if substantially all of a partnership's assets consist of housing, the effective date would be January 1, 1983. However, the proposal would not apply to a partnership if substantially all (i.e., more than 90 percent) of its assets consists of low-income housing which is subject to an accelerated depreciation method.

The proposal would apply to a partnership formed before the effective date if a limited partner contributed money or property to the partnership after the effective date (unless the contribution was made pursuant to a binding agreement entered into on or before the effective date).

3. Audits of Partnerships

Present Law

Partnerships are not taxable entities. Rather, each partner reports his share of the partnership income or loss and tax credits. Partnerships file annual information returns showing the gross income, deductions and credits of the partnership and the allocation of taxable income or loss and credits to the partners.

While the Internal Revenue Service may examine a partnership information return, it cannot, under present law, make adjustments to partnership taxable income at the partnership level which, ultimately, would be binding at the partner level. The Service must instead pursue the adjustment with each partner separately. Further, the statute of limitations on adjustments to tax liability of some partners may expire before the Service can complete its audit work with respect to each partner.

Administration Proposal

The Administration proposal would establish procedural rules allowing the Internal Revenue Service to make an audit determination at the partnership level which, ultimately, would be binding upon the partners if it is either agreed to by a representative of the partnership or sustained in court in litigation between the Service and the partnership. Under these rules, the Service would provide separate notices to each partner both as to the commencement of the audit of the partnership return and the results of the audit. Further, a special statute of limitations would be provided for adjustments of partnership income, loss or credits on the partner's return.

4. Deferred Annuities

Present Law

An annuity contract may provide that annuity payments are to commence shortly after the consideration for the contract is paid (an immediate annuity) or the contract may provide that annuity payments are to commence after an extended period following the date on which the contract was initially purchased (a deferred annuity). Under present law, investment income earned on amounts invested in an annuity contract is not taxed to the policyholder until payments are made under the contract. Investment income earned on assets held

in a life insurance company's reserve for an annuity contract is not taxed to the insurance company to the extent that income is required to be added to the reserve.

If the holder of an annuity contract withdraws a portion of the amount invested in the contract (withdrawals are permitted before annuity payments commence), the amounts withdrawn are not treated as income until all capital invested in the contract has been withdrawn. As annuity payments are made, each payment is allocated between income and capital on the basis of the capital investment in the contract at the time annuity payments began.

Administration Proposal

Under the Administration proposal, investment income on amounts invested in an annuity contract would generally be taxed currently to the policyholder during the accumulation period (i.e., the period beginning when an amount is first invested in the contract and ending when annuity payments commence). An exception would be provided for a single deferred annuity contract designated by the taxpayer (a designated contract) under which the amount invested each year (including reinvested policy dividends) is \$1,000 or less. Transition rules would be provided for existing contracts.

The Administration also proposes that amounts withdrawn from, and loans by the issuer to the holder of, an annuity contract during the accumulation period be considered income until all untaxed accumulations of income have been paid to the policyholder. The change in treatment of amounts withdrawn during the accumulation period would apply to all contracts (including preexisting and designated contracts).

No change would be made in the tax treatment of annuity contracts held under tax-qualified employee benefit plans or of tax deferred annuities for teachers or employees of public charities.

5. Accrual Accounting for Certain Farming Operations

Present Law

Under present law, most taxpayers engaged in farming can use the cash method of accounting and generally can deduct preproductive period expenses when paid. However, with certain exceptions, the Tax Reform Act of 1976 required corporations (and partnerships in which nonexcepted corporations are partners) engaged in farming to use the accrual method of accounting and to capitalize preproductive period expenses (sec. 447). The 1976 Act provided the following exceptions: (1) subchapter S corporations; (2) "family" corporations (in which one family owned at least 50 percent of the stock); (3) corporations with annual gross receipts of \$1 million or less; and (4) nurseries.

In addition, the 1976 Act modified traditional cash accounting for "farming syndicates" by (1) allowing a deduction for prepaid feed, seed or other farm supplies only when used or consumed, (2) requiring capitalization or inventorying of certain poultry expenses, and (3) requiring capitalization of certain preproductive period expenses paid or incurred to raise a grove, orchard or vineyard to maturity (sec. 464). For these purposes, a farming syndicate is a partnership or any other enterprise (other than a corporation which has not elected sub-

chapter S status) engaged in the trade or business of farming if either (1) participation interests are registered or required to be registered with a State or Federal securities agency, or (2) more than 35 percent of the enterprise's losses are allocable to limited partners or limited entrepreneurs (that is, with certain exceptions, persons not actively participating in the management of the farming enterprise).

Administration Proposal

The Administration proposal would eliminate the family corporation exception to the required farm accrual accounting provision. The proposal would also extend the accrual accounting requirement to all farming syndicates, regardless of size, and would provide that State and local taxes other than real property taxes and income taxes would no longer be specifically excepted from treatment as preproductive period expenses.

The proposal would retain the present law exceptions to required accrual accounting and capitalization of preproductive period expenses for (1) subchapter S corporations (other than those classified as farming syndicates), (2) small corporations (those with \$1 million or less in annual gross receipts), and (3) nurseries.

B. MINIMUM TAX PROPOSALS

Present Law

Under present law, individuals pay a minimum tax, in addition to the regular income tax, equal to 15 percent of their items of tax preference in excess of the greater of a \$10,000 exemption or one-half of the individual's regular income tax liability. The items of tax preference are: (1) the excluded one-half of capital gains; (2) the excess of percentage depletion over the adjusted basis of the property; (3) accelerated depreciation of real property; (4) the bargain element of stock options; (5) accelerated depreciation on personal property subject to a lease; (6) the excess of amortization of child care facilities over regular depreciation; (7) the excess of amortization of pollution control facilities over regular depreciation; (8) the excess of amortization of railroad rolling stock over regular depreciation; (9) adjusted itemized deductions; and (10) intangible drilling costs in excess of the straightline recovery of intangibles.

Administration Proposal

The Administration proposal would repeal the offset for half of regular tax liability. All preferences in excess of \$10,000 exemption would thus be subject to the minimum tax. Also, the Administration proposal would delete from the items of tax preference the amount of excluded capital gains from the disposition of the taxpayer's principal residence.

III. DESCRIPTION AND DISCUSSION OF TAX SHELTER AND MINIMUM TAX PROPOSALS

A. TAX SHELTER PROPOSALS

1. At Risk Rule

Present Law

Among the provisions of the Tax Reform Act of 1976 which deal with tax shelters are two "at risk" rules. These rules are designed to prevent a taxpayer from deducting losses in excess of his actual economic investment in the activity involved.

The first of these at risk rules—"the specific at risk rule"—applies to four specified activities: (1) farming; (2) exploring for, or exploiting, oil and natural gas resources; (3) holding, producing, or distributing motion picture films or video tapes; and (4) equipment leasing (sec. 465). This specific at risk rule applies to all types of taxpayers other than regular corporations (that is, corporations which are not subchapter S corporations or personal holding companies).

Under the specific at risk rule, a taxpayer's loss for any taxable year from covered activities is limited to the amount the taxpayer has placed at risk and could actually lose from this activity. Initially, the amount at risk is generally the sum of (1) the taxpayer's cash contributions attributable to the activity, (2) the adjusted basis of other property contributed to the activity, and (3) amounts borrowed for use in the activity with respect to which the taxpayer has personal liability for repayment from his personal assets. Generally, this amount is increased by the taxpayer's share of income and it is decreased by his share of losses from the activity.

The taxpayer is not generally to be considered at risk for the proceeds (or his share of the proceeds) of a nonrecourse loan used directly or indirectly to finance his participation in the activity. Additional rules are provided to prevent avoidance of this rule by cross-collateralization of property involved in two different activities and borrowing from other participants in the same activity. Also, a taxpayer is not considered at risk to the extent his economic participation is protected from loss by guarantees, repurchase agreements or insurance (except casualty insurance).

Losses which may not be deducted for any taxable year because of the specific at risk rule are deferred and may be deducted in any subsequent year in which this at risk limitation does not prevent the deduction.

The other at risk rule—"the partnership at risk rule"—applies generally to activities engaged in through partnerships. This rule (sec. 704(d)) provides that, for purposes of the limitation on allowance of partnership losses, the adjusted basis of a partner's interest does not include any portion of any partnership liability with respect to

which the partner has no personal liability. However, there are two exceptions to this rule. First, the rule does not apply to any activity to the extent that the specific at-risk rule (sec. 465) applies. Second, the rule does not apply to any partnership the principal activity of which is investing in real property (other than mineral property).¹

Administration Proposal

The Administration proposal would revise the at risk rules by applying the specific activity at risk rule to all activities other than real estate. The partnership at risk rule would then be repealed as redundant. The revised at risk rule would also be extended to apply to corporations in which 5 or fewer individuals own more than 50 percent of the stock. In the case of an affiliated group of corporations, the revised at risk rule would apply to all corporations in the group if it applied to the common parent. Finally, the revised at risk rule would require a taxpayer to recapture deductions previously claimed if he received distributions from the partnership after his at risk basis had been exhausted.

Effective date

The proposed changes to the at risk rules under the Administration proposal would apply to losses attributable to amounts paid or incurred in taxable years beginning after December 31, 1978.

Revenue effect

It is estimated that this proposal would increase calendar year 1979 liability by \$14 million, by \$10 million in 1980, \$8 million in 1981, \$5 million in 1982, and \$6 million in 1983.

Issues

The Administration's proposal would amend the specific at risk rule in three ways. The at risk rule would be: 1) extended to apply to direct investments in all types of activities (except real estate), rather than just the four types of activities now covered; 2) extended to apply to certain closely held corporations; and 3) provide for the recapture of previously allowed deductions where there were withdrawals of amounts originally placed at risk.

Extending at risk rules to direct investments

Although the specific at risk and partnership at risk rules do apply to all activities except real estate, they do not apply to direct investments (e.g., investments made directly by individuals, not through partnerships) except for those in the four activities to which the specific at risk rule applies. Essentially, the Administration contends that the lack of any application of the at risk principles to direct investments constitutes a major gap in the tax law in dealing with tax shelter abuses.

Thus, the Administration is proposing a revised at risk rule which would apply to investments (direct or indirect) in all activities except

¹ Recently, the House approved an amendment, under H.R. 6715 (The Technical Corrections bill), to the partnership at risk rule. The amendment deals with ambiguities as to the extent and type of real property activities to which the second exception applies by providing that this exception applies where "substantially all" of the activities of a partnership relate to holding of real property for sale or rental.

real estate. As examples of the tax shelter investment activities to which the revised at risk rule would apply, the Administration cites the direct sale to individuals of master phonograph records,¹ lithographic plates, books, coal mining, and research and development.

Extending at risk rule to closely-held corporations

The Administration proposal would make the at risk rule applicable to closely-held corporations (i.e., those in which five or fewer individuals own more than 50 percent of the stock). This raises the broad issue of whether it is appropriate to exempt corporations from the at risk rules.

The Administration asserts that this proposal would curtail the use of tax shelter deductions by closely-held corporations to avoid the accumulated earnings tax and the personal holding company tax and to shelter income on which owner-employees would otherwise pay tax at the individual level.

Others argue that closely held corporations should not be subject to the at risk rule and point out that the specific at risk rule already applies to personal holding companies and Subchapter S corporations. These types of corporations may represent a higher risk from a tax avoidance standpoint than other closely held corporations.

Some contend that the corporate exemption under the present at risk rules is not justified for any corporations because corporations, being subject to a flat 48 percent normal and surtax tax rate, can and do obtain substantial tax benefits from tax shelter investments. Moreover, it is argued that the corporate exemption will create a concentration of tax shelter investments in the corporate sector. While the Administration proposal would remove the corporate exemption for closely held corporations, those that make this argument state that the proposal does not go far enough.

Essentially, the Administration's reasons for continuing the corporate exemption from the at risk rules for widely held corporations are that these corporations, with the exception of equipment leasing, do not ordinarily enter into tax shelter investments and that these corporations are not affected by the accumulated earnings and personal holding company taxes and thus have no need of tax shelter deductions to avoid their application. Moreover, these corporations are subject to public reporting requirements and other scrutiny which make it unlikely that they would engage in a venture which was questionable under the tax law or which did not make sense from an economic standpoint.

While it recognizes that widely held corporations (particularly, banks and insurance companies) are involved in equipment leasing tax shelter investments, the Administration asserts that these investments have the desirable effect of making the tax incentives for new investment more efficient. Further, it states that, because the same corporate tax rate applies to both the lessee (which is a corporation in almost all cases) and the lessor, the tax benefit is no greater than

¹ While a recent revenue ruling (Rev. Rul. 77-397, 1977-44 I.R.B.) applies the specific at risk rule to the direct acquisition and leasing of master phonograph records, the Administration points out that some tax shelter promoters have taken the position that the ruling is incorrect and have continued to sell these investments.

Congress intended it to be. The Administration asserts that this is distinguishable from the closely held corporation situation, where the tax shelter benefits can, in effect, be passed through the shareholder-employees who are in a higher marginal tax bracket than the flat corporate normal and surtax tax rate.

It is also argued that the proposed widely held corporate exemption could create (or exacerbate) a competitive disadvantage between smaller corporate taxpayers subject to the at risk rule and larger corporate taxpayers not subject to the rule. Moreover, certain administrative problems, discussed below, may be exacerbated if the at risk rule is extended to small corporations.

Withdrawals of amounts originally placed at risk

Under a literal interpretation of present law, the at risk rules may only require the taxpayer to be at risk at the time deductions are claimed. Thus, subsequent withdrawals of the amounts originally placed at risk may be made without the recapture of previously allowed deductions. This would appear to circumvent the intent of the risk limitation and the Administration proposes an amendment which would require the recapture of previously allowed deductions when the amount at risk is reduced by withdrawals.

Tax simplification and administrability

Under present law, the specific at risk rules apply on an activity-by-activity basis. Thus, in the case of a partnership or proprietorship engaged in different activities, an allocation of the amounts at risk must be made. The Administration proposes that the activity-by-activity approach be continued in its expanded version of the specific at risk rule.

The application of the at risk rules to a wide range of activities may result in substantial difficulties for both the Service and the taxpayer in separating the activities involved and allocating amounts at risk among these activities. This problem may not be as acute where individuals are involved, because generally the scope of their operations will often be limited to one activity or will be fairly well defined. On the other hand, corporations (other than those to which the at risk rule already applies) may well be involved in a variety of activities which may prove difficult to sort out. For example, if a closely held corporation is engaged in manufacturing different products, as well as distribution and retail sales of these products, it may be difficult to determine the number of activities in which the taxpayer is engaged. In this regard, the Administration contends that, as a practical matter, most active businesses will not be impacted by the at risk rule because they do not employ nonrecourse financing (except with respect to real estate, which is not subject to the at risk rule).

2. Classification of Limited Partnerships

Present Law

An organization not formally incorporated may be classified under the Internal Revenue Code as either a partnership or a corporation. This classification determines the organization's tax treatment. Unless an election to be taxed under subchapter S of the Code is in effect, an organization classified as a corporation is subject to tax with respect to its own income, losses, deductions and credits. However, if an organization is classified as a partnership for tax purposes, it is not subject to the income tax, and its items of income, loss, deductions and credits are passed through to the partners and are taken into account separately on each partner's return.

The Code provides that the term "corporation" includes associations, joint-stock companies, and insurance companies (sec. 7701(a)(3)). Also, under the Code, a partnership is defined as including a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not a trust, estate or corporation (sec. 7701(a)(2)). These general definitions, however, leave substantial ambiguity as to whether many types of unincorporated organizations should be treated as "associations taxable as corporations" or as "partnerships."

The leading case authority setting forth principles to determine whether an unincorporated organization should be treated as a corporation, a partnership, or a trust¹ is the decision of the Supreme Court in

Morrissey v. Commissioner, 296 U.S. 344 (1935). This case set forth six characteristics ordinarily found in a "pure" corporation which, taken together, distinguish it from other organizations. These characteristics are: (1) associates, (2) an objective to carry on business and divide gains therefrom, (3) continuity of life, (4) centralization of management, (5) liability for corporate debts limited to corporate property, and (6) free transferability of interests. The *Morrissey* decision indicates that an unincorporated organization is to be treated as a corporation if the corporate characteristics are such that the organization more nearly resembles a corporation than a partnership or trust.

The existing Treasury regulations (Reg. § 301.7701-2) generally follow the *Morrissey* decision in identifying the relevant corporate characteristics. The regulations provide that, since associates and an objective to carry on business for profit are essential characteristics of all organizations engaged in business for profit, the characteristics which are to be examined in classifying an organization as a partnership or a corporation are continuity of life, centralization of management, liability for corporate debts limited to corporate property, and

¹ In general, a trust is taxed on undistributed income, and currently distributed income is taxed to the beneficiaries.

free transferability of interest. The regulations indicate that a partnership formed pursuant to the Uniform Partnership Act or Uniform Limited Partnership Act lacks continuity of life, and, in most circumstances, would not have the corporate characteristics of limited liability and centralization of management (See Regs. §§ 301.7701-2 (b) (3), (c) (4), and (d) (1)).

The regulations further provide that an unincorporated association will not be classified as a corporation unless the organization has more corporate characteristics than noncorporate characteristics. Thus, if a limited partnership has centralized management and free transferability of interest, but lacks continuity of life and limited liability (and has no other characteristics which are significant in determining its classification),² the limited partnership would be classified as a partnership under the regulations (Reg. § 301.7701-2(a) (3)).

This preponderance approach of the regulations makes it relatively easy for a tax shelter promoter to achieve partnership classification for a limited partnership in which the great bulk of the interests are held by limited partners who have limited liability for the organization's debts and no voice in management. Thus, despite the fact that a limited partnership may have the corporate characteristics of centralized management and free transferability of interest, it can avoid having the characteristics of continuity of life (since the death, insolvency, bankruptcy, etc. of the general partner would dissolve the partnership under the Uniform Limited Partnership Act) and limited liability (since a general partner is liable for the organization's debts).

Background

The regulations above described were developed and promulgated in their final form when the principal controversy in the classification of organizations was the proper treatment of professional service associations. In this controversy, the Treasury was seeking to have these associations treated as partnerships to prevent a more generous allowance of retirement benefits (and certain other fringe benefits).

These regulations were recently criticized by the Tax Court in the case of *Phillip G. Larson*, 66 T.C. 159 (1976). In this case, the Tax Court held that the real estate syndicates involved were properly classified as partnerships under the regulations since two of the four key characteristics were consistent with partnership treatment. However, the Tax Court criticized the regulations and indicated that the *Morrissey* decision did not require the preponderance approach of the regulations.

Furthermore, on January 5, 1977, the Treasury Department published proposed new regulations on classification of organizations.³ Under the proposed regulations, the preponderance approach would have been replaced with a resemblance test, under which an unincorporated entity, such as a limited partnership, might have been deemed more nearly to resemble a corporation than a partnership on the basis of as few as two of the four critical corporate-type characteristics.

² In general, it appears that courts have been unwilling to use "other characteristics" as a basis for the classification of an organization. See *Zuckman v. United States*, 524 F. 2d 729 (Ct. Cl. 1975); *Phillip G. Larson*, 66 T.C. 159 (1976).

³ See Prop. Reg. §§ 301.7701-1, 301.7701-2, and 301.7701-3 (42 F.R. 1038).

Also, significant changes were made in the rules concerning when an organization has continuity of life, limited liability, and free transferability of interest.⁴

Generally, the proposed changes would have made it much more difficult for a limited partnership in which a large portion of the interests were held by limited partners to be classified as a partnership for tax purposes.

Under the transitional rules of these proposed regulations, in the absence of organizational changes, existing organizations would not have been affected by the proposal until their fourth taxable year following publication of an appropriate Treasury decision finalizing the proposed regulations.

These proposed regulations were withdrawn within 24 hours after they were proposed. It was later announced, on January 14, 1977, that the Treasury Department was no longer considering a proposed amendment to the regulations classifying organizations, including the definition of partnerships, for purposes of Federal taxation.

Administration Proposal

The Administration proposal would treat a partnership formed after the effective date as a corporation for tax purposes if it has more than 15 limited partners. However, if more than 90 percent of the partnership assets consists of new low-income housing, this rule would not apply.⁵

Effective date

Generally, this provision would apply only to partnerships formed after December 31, 1978. However, if substantially all of a partnership's assets consist of housing, the effective date would be December 31, 1982. The proposal would not apply to an organization if substantially all of its assets consists of new low-income housing.

With respect to pre-1979 limited partnerships, the tests provided in the proposal would also apply if the limited partners contribute increases after the effective date or if the limited partners contribute money or property to the partnership after the effective date and the contribution is not made pursuant to a binding agreement entered into on or before the effective date.

Revenue effect

It is estimated that this proposal would have a negligible effect on tax liabilities.

⁴For example, under these proposed regulations, it was provided that an organization resembles a corporation with respect to limited liability if the percentage of the interests in the organization which does not entail personal liability for claims against the organization is substantially in excess of the percentage of interests that does entail personal liability. Also, the personal liability characteristic would be disregarded if either (1) the nature of the business operation precludes the possibility of any claim against the organization for an amount in excess of capital invested, or (2) no member of an organization has substantial assets other than those invested in the organization.

⁵Under the Administration's proposal, the maximum number of limited partners in a partnership—15—is the same as the maximum number of shareholders that would be permitted in a subchapter S corporation under another portion of the Administration's tax proposals. Thus, these two proposals would generally equate the tax treatment of an electing subchapter S corporation and a limited partnership by providing that, in either form of organization, a pass-through of income or loss could be achieved only if 15 or fewer investors were involved.

Issues

The main issue is whether the classification of a limited partnership for income tax purposes as either a partnership or corporation should hinge in many cases on only one factor—the number of limited partners. It is argued that even if the number of limited partners is a relevant factor in the determination of the tax status of a limited partnership, other factors taken into account under present law (continuity of life, centralization of management, limited liability and free transferability of interest) are also relevant to this determination.

The Administration contends that publicly marketed syndicated partnerships are being used as the vehicle for many thousands of tax shelters. It asserts that a syndicated partnership is, to all intents and purposes, the equivalent of a corporation and the same tax rules should apply to both. In support of this assertion, it points out that: limited partners are not responsible for the debts of the partnership and have no voice in its day-to-day management; as a practical matter, the syndicated partnership has the same ability to maintain its existence as a corporation; and a limited partner has the same ability to transfer his partnership interest as he would stock in a comparably sized corporation.

Another issue is whether this proposal would have the effect of restricting the use of limited partnerships to wealthier taxpayers. Thus, it is argued that the Administration proposal would allow wealthier taxpayers who are able to make very large investments to invest in limited partnerships with fewer than 15 limited partners, and thereby obtain the passthrough of income, losses and credits from limited partnerships, whereas this treatment would not be available in many cases for persons who can only afford modest investments.

The main purpose of the proposed 15 limited partner rule is to curtail the use of partnership tax treatment as a tax shelter vehicle. Yet, it is argued that most limited partnerships having 15 or more limited partners, particularly those involved in real estate ventures, do not rely upon tax shelter losses to attract investor capital. These investors, it is pointed out, are attracted by the prospect of current cash yield and long-term capital appreciation. Thus, it is contended that as a result of the application of corporate (double tax) treatment to these ventures, the real estate and construction industries would lose a major source of equity capital. In this regard, the Administration points out that the real estate trust provisions of the Code do permit large numbers of investors to invest in real estate without incurring a double tax.

It is also contended that many other industries, which are not affected by the at risk rules in given instances (because nonrecourse financing is not employed in the particular activity involved) would be adversely impacted by the proposed corporate tax treatment. Examples given of these industries are oil and gas operations and, in some cases, equipment leasing.

Simplification and administerability

The Administration contends that many of the provisions of partnership taxation (e.g., special allocations, special elections, limitations calculated separately by each partner) were intended to offer flexibility and to preserve some degree of individuality for the members of small partnerships. In the case of large syndicated partnerships

with many passive investors, however, it contends that the application of these provisions becomes unnecessarily complicated and that the proposed corporate tax treatment of these partnerships would eliminate this complication.

One issue regarding the Administration proposal relates to the possible complexity involved in the determination of the number of limited partners. Thus, a problem may arise in connection with attempts to avoid the Administration proposal by forming a number of limited partnerships, each composed of 15 or fewer members. This device would be dealt with by a series of attribution rules. But these rules may be somewhat complex in their application and administration. Another problem may arise in connection with the general partner or the Service being able to count the limited partners where there are nominee partners or where a partner is itself a partnership.

3. Audit of Partnerships

Present Law

For income tax purposes, partnerships are not taxable entities. Instead, a partnership is a conduit, in which the items of partnership income, gain, loss, deduction and credit are allocated among the partners for inclusion in their respective income tax returns.

Partnerships are required to file an annual information return setting forth the partnership income, deductions and credits, names and addresses of the partners, each partner's distributive share of partnership income, gain, loss, deduction and credit, and certain other information required by the regulations. Neither the partnership nor any partner is subject to a civil penalty for failure to file, or for late filing of, a partnership information return. The income tax return of each partner does not include detailed information with respect to partnership items. It only includes the net amount of each partner's share of partnership items. Under current administrative practice, the detailed information pertaining to these amounts is only required to be reported on the partnership information return.

Since a partnership is a conduit rather than a taxable entity, adjustments in tax liability may not be made at the partnership level. Although the Service may examine the partnership books and records, any adjustments must be made separately for each partner.¹

A settlement agreed to by one partner with the Service is not binding on any other partner or on the Service in dealing with other partners. Similarly, a judicial determination of an issue relating to a partnership item is conclusive only as to those partners who are parties to the proceeding. Thus, each separate deficiency or overpayment of each partner attributable to partnership items may be subject of a separate administrative proceeding, and, at the option of each partner, the subject of a separate judicial proceeding.

Generally, under present law, an income tax deficiency may be assessed only if a statutory notice of deficiency is mailed to the taxpayer. The taxpayer then has the opportunity to petition the Tax Court for a judicial determination of his individual tax liability. Alternatively, the taxpayer may pay the assessed tax, file a claim for refund with the Service, and if the claim is denied or if no action taken within 6 months, he may file a suit for refund in the U.S. District Court or the U.S. Court of Claims.

In addition, the Code provides a period of limitations during which the IRS can assess a tax or a taxpayer may file a claim for refund. Generally, the period is 3 years from the date the tax return is filed (if filed before the due date, the due date is treated as the date

¹The Service cannot require any group of partners to join together in a single proceeding and subject themselves to a mutually binding determination. However, partners may voluntarily join together in a single binding administrative or judicial proceeding.

filed). If more than 25 percent of the gross income is omitted from a return, the statutory period for assessment is 6 years. In the case of a partnership, the income tax return of each of the partners begins that individual partner's period of limitations. The date of filing of the partnership return does not affect the period of limitations. In order to extend the period of limitations with respect to partnership items, the Service must obtain a consent for extension of the statute of limitations from each of the partners—not the partnership. Generally, an agreement to extend the period of limitations relates to all items on the partner's return.

Background

The problems of auditing each partner individually with respect to partnership items, although perhaps troublesome, are not severe in the case of the vast majority of partnerships that have few partners. The audit problems become more acute, however, in connection with those partnerships having a large number of partners and with those partnerships which are multi-tiered (e.g., where the partners of the partnership are partnerships which, in turn, have partnerships as partners).

Increase in partnerships

According to Department of Treasury estimates, the total number of partnerships increased 8.2 percent between 1972 and 1975. Large partnerships with more than 50 partners each, however, increased 39.8 percent. The largest of these partnerships, those with more than 500 partners each, increased by 76.4 percent. Table 1 shows the distribution of partnerships by size for 1972 through 1975.

Table 1.—Growth in Size of Partnerships—1972 through 1975¹

Number of partners per partnership	Total number of				
	2-10	11-50	51-500	501 or more partnerships	
Year:					
1975.....	1, 013, 138	54, 941	4, 470	545	1, 073, 094
1974.....	1, 008, 623	49, 137	4, 131	377	1, 062, 268
1973.....	989, 622	45, 505	3, 615	350	1, 039, 092
1972.....	947, 804	40, 620	3, 279	309	992, 012
Percentage change, 1972-75.....	6. 9	35. 5	36. 3	76. 4	8. 2

¹ All figures are estimates based on samples. Data by number of partners available only from 1972.

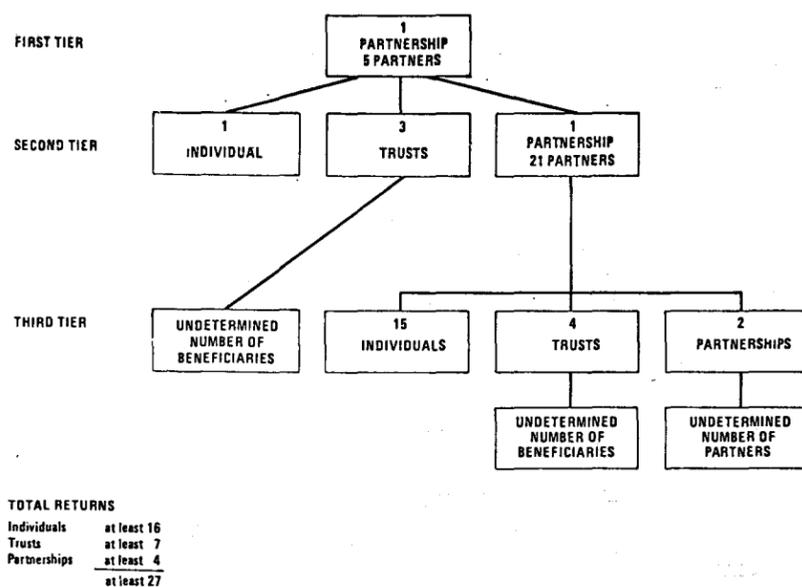
Source: Internal Revenue Service.

Current audit procedures

Once a partnership return has been selected for audit, the Service must identify and control the income tax returns of all partners to whom it may want to issue a deficiency notice. In the case of complex tax shelter arrangements, it is often difficult to identify the taxpayers who may ultimately be affected by an adjustment to a partnership item. The partnership, for example, may be composed of several tiers, the partners being trusts, corporations, individuals and other partner-

ships. A schematic drawing of such a tiering arrangement, constructed by the Department of Treasury from IRS records, is shown in Table 2.

Table 2.—Schematic of a Tax Shelter Partnership¹



¹ Developed by the Department of Treasury from Internal Revenue Service Records.

If the audit of the partnership return is expected to take a considerable amount of time, although troublesome, are not severe in the case of the vast majority of partnerships that have few partners. The audit problems become more acute, however, in connection with those partnerships having a large number of partners and with those partnerships which are multi-tiered (e.g., where the partners of the partnership are not only by the fact that it is difficult to identify these taxpayers, but also by the fact that in many cases partners are widely dispersed geographically).

While examining the books and records of the partnership, the Service usually deals with the general partner who signed the return. Once the Service has decided upon the audit adjustments it considers appropriate, a Revenue Agent's Report is prepared for the partnership. Other IRS districts are informed of the results of the audit and may use the information to pursue adjustments on returns of affected taxpayers within that district.

The procedure for each partner for whom a deficiency is proposed is the same. First, he is issued a "30 day letter" which describes the proposed adjustment, deficiency and the Service position. It states that the taxpayer has 30 days to contest the proposed assessment administratively. Within the 30 days the partner may request a district or appellate division conference on the matter. Thereafter, a "90 day letter" is

issued. This letter is a "notice of deficiency" issued after either the expiration of the 30 day letter period or an administrative conference which fails to resolve the issue. It allows the partner to petition the United States Tax Court for resolution of the issue together with any other issues relating to his tax liability for that year. If no petition is filed within the 90 days, an assessment of the deficiency is made and the deficiency must be paid. After payment of the deficiency, the partner may, within 2 years, file a claim for refund. If the claim is denied (or after 6 months, if no action is taken), the partner may sue for refund in the United States District Court or the United States Court of Claims.

Administration Proposal

In general.—Essentially, the Administration proposal treats the partnership as a separate entity for purposes of administratively and judicially determining the correct income, gain, loss, deduction, and credits which are allocable to each of the partners. Whereas, under present law, each partner has the right at both the administrative and judicial stages individually to contest any proposed adjustments in his share of the partnership items, the Administrative proposal would provide for partnership level administrative and judicial determinations concerning partnership items which would be binding on all partners.

Penalty for failure to file a timely partnership return.—Under the proposal, a partnership would be subject to a civil penalty for failure to file a return or filing a late return. The penalty would be \$50 per partner for each month the return is late (not to exceed 5 months in the aggregate). Each general partner would be jointly and severally liable for the penalty. This penalty may be waived if reasonable cause is shown for the late filing.

Statute of limitations.—Generally, the Service would have three years from the date the partnership return is filed to provide the partners with notice of a final administrative determination with respect to items reflected on the partnership return. Thus, with respect to IRS final administrative determinations of partnership items, the proposed partnership return statute of limitations would be substituted for the statute of limitations pertaining to each partner's own return. This notice would be similar to the current law notice of deficiency. Failure to timely issue this notice would, in the absence of fraud, preclude any adjustments by the Service at the partnership level which would be binding upon the partners. Any general partner could execute a consent to extend the partnership statute of limitations.

The 3-year statute of limitations would not apply in the case of a fraudulent partnership return. In this instance, the statute would be kept open indefinitely for partners participating in the fraud and for a 6-year period for partners not participating in the fraud. The statute would also be kept open for 6 years if there was an omission of 25 percent or more of the partnership's gross income.

Treatment of amounts shown on partnership return.—Each partner would be required to conform his individual tax return to the treatment of an item on the partnership return. The Service could summarily assess any tax resulting from disparate treatment.

Claim for adjustment.—The partnership would also be accorded three years following the filing of its return to file a “claim for adjustment” of items as originally reported by the partnership. If the Service took no action on that claim for 6 months, or if the Service denied that claim, the partnership could, after satisfaction of certain conditions described below (*under judicial review*), seek judicial review of the claim in the United States District Court (for the district in which the partnership’s principal place of business is located) or in the United States Court of Claims. That suit would be required to be commenced within two years of any denial of the claim by the Service.

Examination of partnership books and records.—Ordinarily, an initial step in the audit of a partnership return is the Service request to inspect the partnership’s books and records. Under the Administration’s proposal, the Service would be required to notify the partnership in writing that it is commencing an audit of the partnership and wants to examine the books and records. Within 30 days of that notice, the partnership would be required to provide the Service with a correct list of names and addresses of partners of the partnership for the year under audit (referred to as “first tier partners”), and other taxpayers (known to the partnership) whose tax liability could be affected by a partnership adjustment (referred to as “real parties in interest”).

Within 60 days after notifying the partnership of the commencement of the audit the Service would be required to send notice to first tier partners and known real parties in interest that the audit had begun and that they had a right to participate in the proceedings. The notice would be sent by certified or registered mail to the address provided by the partnership under the above rule. If the partnership does not provide current names and addresses the Service may fulfill the notice requirement by sending notice to the partners at addresses listed in the latest partnership return under audit. Notice to first tier partners and known real parties in interest would constitute notice to all unknown real parties in interest. Thus, for example, notice to a trust which is a partner in the partnership under audit would constitute notice to all the beneficiaries of that trust who may ultimately be affected by a partnership adjustment.

At the time the initial notice is received, each first-tier partner and each subsequent tier partner, upon receipt of notice, would be required, to the extent known, to disclose to both the Service and the partnership the identity of any other real parties in interest. The first-tier partner and each subsequent tier partner would also be required to notify each of these real parties in interest of the proceeding. All subsequent notices would be required to be given by the partnership both to first-tier partners and to identified real parties in interest.

Partnership control of administrative proceedings.—Generally, any general partner would be able to act in administrative proceedings for and on behalf of the partnership and take actions that would be binding upon the partnership, the partners and real parties in interest. This authorization would extend to any general partner regardless of any contrary provision of the partnership agreement. A partnership wishing to limit the number of general partners authorized to act on behalf of the partnership with respect to its tax matters could do so

by filing a Power of Attorney with the service removing this authority from all general partners other than those listed as fully authorized representatives on the Power of Attorney.

Notices required to be given by a partnership during the course of the audit and related administrative procedures.—During the audit proceeding, the partnership would be required to give prior notice to the first-tier partners and identified real parties in interest of certain occurrences in order to give these parties the opportunity to provide comments or to participate in the audit proceedings. Notice is required of the following events: (1) any meeting requested by the partnership with the Service to discuss the Service's notice of proposed adjustments; (2) any notice by the Service proposing a redetermination of taxable income or loss, etc., issued to the partnership; (3) any request by the partnership to have a conference appealing the results of the audit report; (4) any settlement proposals made by either the partnership or the Service. The partnership would be required to certify that these notices had been given in order to be accorded any review or settlement rights.

IRS notice of final administrative determination.—The Administration proposal contemplates that the partnership would have the right to appeal administratively within the Service any adjustments proposed in the audit report of an IRS agent. A properly and timely filed appeal would give the partnership the right to a district or appellate conference. If these appeal rights are exhausted or are not exercised, the Service would then issue a notice of final administrative determination reflecting the proposed adjustments in the partnership's taxable income or loss, etc. This notice would be sent by certified mail to the partnership, the first-tier partners, and the identified real parties in interest.

Judicial review.—The partnership would have 90 days from the date of the issuance of the notice of final administrative determination to file an action with the United States Tax Court. If the partnership does not file a petition with the Tax Court, the Service may assess any deficiency against partners resulting from the final administrative determination. However, if the partnership files a timely claim for adjustment with the Service (discussed above), the partnership could seek judicial review of that claim in the United States District Court (for the district in which the partnership's principal place of business is located), or in the United States Court of Claims at any time after the earlier of (1) six months following the filing of the claim or (2) the date on which the Service denies the claim, and within 2 years following the date of any denial of the claim.

In the case of actions in the United States District Court or the United States Court of Claims, partners having at least a 25-percent aggregate interest in the income or loss of the partnership, and who are adversely affected by the Service's final administrative determination, would be required to pay the additional tax that would result from the determination. Alternatively, actions could be taken in these courts if the partners elected to pay 10 percent of the sum of the differences between the taxable income or loss, special items and credits, as reflected on the partnership return, and the taxable income or loss, special items and credits as set forth in the notice of final administrative determination. In the case of a claim for administra-

tive adjustment, where the Service does not make a final administrative determination, no payment would be required.

Only a general partner could initiate an action on behalf of the partnership. However, each partner and real party in interest could participate in the proceeding.

Assessments following a final determination.—In order for the Service to assess additional tax liability with respect to a “final determination” at the partnership level, it would be required to provide each first-tier partner and identified real party in interest with a notice of final determination of partnership taxable income or loss, etc. A final determination may be reached either administratively (by settlement or by failing to seek judicial review) or judicially.

The Service could assess additional tax liability arising from a final determination at any time within the later of (1) one year following the date of mailing of notice of final determination which was no longer subject to appeal, or (2) one year following written notice to the Service by first-tier partners of the identity of the real parties in interest.

Within 3 months following the mailing of the notice of final determination, each partner and real party in interest would be required to file an amended return reflecting the adjustments contained in the notice. Failure to file the amended return within this 3-month period would give the Service the right to proceed with a summary assessment against the taxpayer of any additional tax liability related to the adjustments contained in the notice of final determination, and would subject the taxpayer to a penalty equal to 5 percent of any deficiency related to the final determination.

Failure by the Service to give any partner or real party in interest a required notice would preclude it from assessing these parties any additional tax in accordance with the partnership level determination. These partners would then be bound by the partnership return as if it had not been audited by the Service. All other partners are bound by the partnership level determination unless a binding individual settlement is reached in accordance with the new partnership audit rules (see below).

Negotiations and agreements with individual partners.— The Administration proposal would allow the partners and real parties in interest to execute closing agreements (or similar binding documents) with respect to their own tax liabilities relating to the partnership during the administrative determination of the partner’s or real party in interest’s liability. All settlements relating to the partnership items would be conducted in the district having jurisdiction over the partnership return. As a general rule, these closing agreements could only be executed following the issuance of a notice of proposed adjustment of the partnership’s taxable income or loss, etc., but before the issuance of a notice of final determination.

Prohibition against litigation of partnership issues by partners.— Under the Administration proposal, the Service and the individual partners would be prohibited from litigating any partnership issues in suits involving individual partners. Thus, the Service could not include any tax deficiency arising from a partnership issue in a notice of deficiency sent to an individual partner with respect to that partner’s own liability for a taxable year. Similarly, a partner could not include

any amounts of tax arising from a partnership issue in any claim for refund or suit for refund which he may file.

Effective date

Partnerships existing as of January 1, 1979 would be subject to the rules of this proposal starting with the second taxable year of the partnership beginning after December 31, 1978. All partnerships formed after December 31, 1978 will be subject to the rules of this proposal.

Revenue effect

It is estimated that this proposal would have a negligible effect on tax liabilities.

Issues

Administration position generally

The Administration claims that present procedural rules make it extremely difficult to effectively audit partnerships and their partners. The difficulties can be traced to three basic problems. First, although present law requires that partnership information returns be filed, there is no civil penalty, or any effect on a partner's statute of limitations, for failure to do so. The Administration claims that many partnerships do not file the required return, or file them late.

Second, in the case of large multi-tiered partnerships, it is difficult to determine the identity of the taxpayer who will ultimately be affected by a change in a partnership item. This problem is caused in part because many partnership information returns are not filed, or are incomplete or inaccurate, and in part because of the convoluted lines of ownership in the large multi-tiered tax shelter partnerships.

Third, once the partners have been identified, the Service must deal with each partner individually. Thus, if the Service needs more time to complete the audit than the three years prescribed by statute (as is often the case in very large, complex audits), it must secure consents to extend the statute of limitations from each partner individually. Further, if the Service proposes an adjustment to a partnership item, each partner may contest it individually, both at the administrative and judicial levels. Finally, any suit involving a partner must include all adjustments with respect to that partner for that year.

Essentially, the Administration's solution to these problems is to treat the partnership as an entity for purposes of audits and settlement of disputes at both the administrative and judicial levels. Thus, all audit determinations and administrative and judicial proceedings pertaining to the partnership would be conducted at the partnership level.

The issues presented by each of the three problems dealt with in the Administration proposal are discussed below.

Filing of partnership returns

The Administration proposal would assess a civil penalty for failure to file (or late filing of) a partnership information return, and would extend partner's individual statutes of limitation on assessment of partnership items. The simple expedient of providing the Service more data in the form of returns enables it to identify more partners. Furthermore, the process of selecting potential tax shelter partnerships for audit would be more effective. Automatic limitations period ex-

tensions ensure that the partnership level audit will be effective at the partner level.

The imposition of a penalty may exacerbate other existing problems. Under present law, it is often difficult to determine whether a particular venture is a partnership. Moreover, in many cases, the owners of a small, informally run, business are unaware that a partnership return should be filed. It has been suggested that this penalty should only be imposed on the partners of partnerships having a certain number of partners and/or a certain amount of income or loss.

Although the penalty may be waived by the Service for reasonable cause, the partner's statute of limitation for partnership items would not begin to run until a partnership return is filed.

Identifying partners

The Administration proposal would require the partnership to provide a list of partners at the commencement of an audit of the partnership. At that time, a notice of the commencement of the audit would be sent by the Service to these "first tier" partners, and they would be directed to notify lower tier parties (e.g., trust beneficiaries of a trust holding a partnership interest). Further, each partner would be required to notify the Service and the partnership of the identity of "real parties in interest" to whom he is responsible. This requirement would apply throughout all tiers of the organization.

Timely filed partnership information returns would help the Service identify partners, since the return calls for disclosure of the name, address, social security number (or employer identification number) and percentage interest of each first tier partner. However, first tier partners presently are not required to notify lower tier partners of the commencement of an audit. In this regard, the Administration contends that its proposal to require notice to lower tier partners would protect the interests of these partners. Some argue that to require them to do so is excessively burdensome. Others argue that since creation and use of complex tiering arrangements is of the taxpayer's choice, he should not be able to use such complexity to avoid identification of the real parties in interest, even though the arrangement also serves a legitimate business purpose.

It has been suggested that it may be appropriate to adopt a rule similar to the Administration proposal, in which identification of lower tier partners is not required to be made except in the case of an audit. Under such a rule, not all partnerships would be burdened by disclosure requirements, but the Service would be assured access to the information it needs to perform an effective audit.

In order to ensure that the Service could not be disadvantaged by a partnership's failure to disclose the identity of lower tier partners, the Administration further proposes that a partner's statute of limitation (only with respect to partnership items) would not run until at least one year after his identity became known to the Service. Some have argued that such a rule is objectionable on two grounds. First, it creates a separate statute of limitations for partnership items vis-a-vis other items in a partner's return. This raises many other complex issues. Second, the undisclosed partner could be "penalized" because an upper tier partner failed to disclose his identity to the Service or to notify the undisclosed partner of the Service's request. Those who object to the rule believe it would be fairer to assess a

monetary penalty on the party who failed to make the disclosure. In support of the Administration's proposal, it is argued that the real problem is the running of the statute of limitations before the Service can locate a partner and assess the deficiency. The undisclosed partner, it is argued, should not be able to benefit by escaping a tax assessment establishing his proper tax liability, whether or not he was at fault for failure to disclose his identity. Further, the Administration asserts that a lower tier partner may protect his rights by notifying the Service of all partnerships in which he has an interest.

Unified administrative and judicial proceedings

The third component of the Administration's proposal provides for unified administrative and judicial proceedings on partnership issues. Under the proposal, a general partner would represent the partnership in any proceeding, while all other partners could intervene on their own behalf if they disagreed with the position taken by the partnership. A final determination would be binding on all partners, even though not all of them agreed on the resolution of the issues.

It is argued this component of the proposal presents the most complexity, and that it raises fundamental issues of due process and fairness. Essentially, the committee is being asked to balance the Government's need for effective enforcement of the tax law against traditional notions of taxpayers' rights in tax controversies.

There are two principal issues relating to fairness of treatment of the taxpayer. First, the proposal results in a partner's tax liability being determined in at least two, perhaps more, separate proceedings: One for his nonpartnership items; and an additional proceeding for each partnership to which he belongs. Coordinating these proceedings may be tremendously complex. The committee may wish to weigh the benefits to the Service of avoiding multiple proceedings for a single partnership against the detriment to the taxpayer of requiring multiple proceedings with respect to his tax liability for a particular taxable year.

Second, the Administration proposal does not provide partners who disagree with a settlement agreed to by the partnership with the opportunity to assert their view in court. Thus, minority partners may be denied a judicial hearing of their views. Where partners have conflicting interests (such as in a liquidation of a partnership or issues involving allocations among partners), this right may be of major importance.

In addition to the issues discussed above, other issues involved regarding the proposed unified proceeding include:

(1) Who should represent the partnership when there are different partners in the year under audit than in the later year when the audit commences? Would it make a difference if the issue under audit has significance for future years, such as depreciation?

(2) Under the Administration proposal, the initial notice of audit and notice of final determination are issued by the Service. All notices in between these two are to be issued by the partnership. Should the partnership be required to issue certain of these notices during progress of the audit, especially where there is potential for conflict between partners?

(3) Where a partner has litigated his return on issues other than the partnership items, may those issues be reopened if a partnership adjustment bears on their determination? For example, perhaps the partner did not litigate an issue (such as minimum tax) because it was not material, but on later partnership audit, the adjustment becomes material. May the partner reopen the minimum tax issue in light of the subsequent partnership audit adjustment?

(4) Tax assessments to the partners may involve more than mere mathematical adjustments. As the adjustment flows through various tiers, substantive determinations of allocation or other effects may need to be taken into account. Do they require going through the audit and appeal procedure at each tier?

4. Accrual Accounting for Farming Corporations

Present Law

In general

Under present law, a taxpayer is required to use a method of accounting for tax purposes which clearly reflects income (sec. 446). Most nonfarm taxpayers who are in the business of selling products are required to report their gross income using the accrual method of accounting and to accumulate their production costs in inventory until the product is sold. However, by reason of administrative rulings issued more than 50 years ago, taxpayers engaged in farming have been allowed to report their income and expenses from farm operations on the cash method of accounting, which does not require the accumulation of inventory costs. Except for special capitalization rules applicable to citrus and almond groves, farmers also have been allowed to deduct the cost of seed and young plants purchased in one year which are intended to be sold as farm products in a later year.¹ In addition, administrative rulings have permitted farmers to deduct currently many of the costs of raising farm assets (such as costs related to breeding animals, orchards and vineyards) which are used in the trade or business of farming. (In nonfarming businesses, such as manufacturing, similar costs generally are treated as capital expenditures and are depreciated over the useful lives of the assets acquired.) The special farming tax rules discussed above are still generally applicable to most farmers, although some restrictions were imposed on certain farming corporations and "farming syndicates" by the Tax Reform Act of 1976.

Also, under the accrual method of accounting as applied to farming, if crops are harvested and unsold at the end of the taxable year, the costs attributable to such crops cannot be deducted in the taxable year but must be treated as inventory. However, even under the accrual method, it had been a long-standing Treasury practice to permit a farmer to deduct expenses paid in the taxable year so long as the crops to which these expenses relate are unharvested at the end of the taxable year. (I.T. 1368, I-1 C.B.72 (1922).) In 1976 the Internal Revenue Service reversed this long standing practice and ruled that an accrual method taxpayer engaged in farming is required to inventory growing crops (unless the taxpayer uses the crop method of accounting).² The effective date of this ruling was postponed so that it applies only to taxable years beginning on or after January 1, 1978.³

¹ However, a farmer has not been allowed to deduct the purchase price of livestock, such as cattle which he intends to fatten for sale as beef.

² Rev. Rul. 76-242, 1976-1 C.B. 132. Under the crop method of accounting, if a farmer is engaged in producing crops, and the process of gathering and disposing of them is not completed in the year in which the crops were planted, the costs of producing, gathering and disposing of the crops are taken into realized. The ruling was to be effective for taxable years beginning on or after June 28, 1976, Treas. Regs. § 1.162-12(a).

³ Rev. Rul. 77-64, 1977-1 C.B. 136.

Farming corporations—1976 Act

With certain exceptions, the Tax Reform Act of 1976 required corporations (and partnerships in which non-excepted corporations are partners) engaged in farming to use the accrual method of accounting and to capitalize preproductive period expenses (sec. 447). However, subchapter S corporations, family corporations (in which one family owns at least 50 percent of the stock), corporations with annual gross receipts of \$1 million or less, and nurseries are not required to use the accrual method of accounting or to capitalize preproductive period expenses.⁴

In general, "preproductive period expenses" which are required to be capitalized are any expenses which are attributable to crops, animals, trees or to other property having a crop or yield, during the preproductive period of the property and which are otherwise allowable as deductions for the taxable year. In the case of property having a useful life of more than one year, which will produce more than one crop (such as an orchard or vineyard), the preproductive period extends until the disposition of the first marketable crop or yield. In the case of other farm property, such as annual crops and animals with useful lives of less than one year, the preproductive period includes the entire period prior to the disposition of the crop (or animal). However, the term "preproductive period expenses" does not include taxes and interest, and it also does not include any amount incurred on account of fire, storm, flood, or other casualty, or on account of disease or drought.

A taxpayer who is required to change to an accrual method of accounting (or to revise his accrual method of accounting to capitalize preproductive period expenses) pursuant to the 1976 Act is generally allowed to spread the accounting adjustments required by the change in method over a period of ten years unless the Secretary of the Treasury by regulations prescribes different periods in various cases.

The 1976 Act provisions generally are effective for taxable years beginning after December 31, 1976. However, the Tax Reduction and Simplification Act of 1977 provided a one-year postponement of the effective date for certain corporations controlled by two or three families.

Farming syndicate provisions—1976 Act

The 1976 Act modified traditional cash accounting for "farming syndicates" by (1) allowing a deduction for prepaid feed, seed, or other farm supplies only when used or consumed; (2) requiring capitalization or inventorying of certain poultry expenses; and (3) requiring capitalization of certain preproductive period expenses paid or incurred to develop a grove, orchard, or vineyard (secs. 278(b) and 464).

⁴The 1976 Act also provides special rules which permit certain corporations to use an "annual accrual method of accounting." An annual accrual method of accounting is a method of accounting under which revenues, costs, and expenses are computed on an accrual method of accounting and the preproductive period expenses incurred during the taxable year are charged to crops harvested during that year or are deducted currently. To be eligible to use this method, a corporation (or its predecessors) must have used this method for a 10-year period ending with its first taxable year beginning after December 31, 1975, and substantially all the crops grown by the corporation must be harvested not less than twelve months after planting.

In general, a farming syndicate is a partnership or any other enterprise (other than a corporation which has not elected to be subject to Subchapter S) engaged in the trade or business of farming if either (1) participation interests are registered or required to be registered with a State or Federal securities agency or (2) more than 35 percent of the enterprise's losses are allocable to limited partners or limited entrepreneurs (that is, with certain exceptions, persons not actively participating in the management of the farming enterprise).

With respect to farming activities other than those conducted by enterprises in which securities have been registered or required to be registered, the 1976 Act specifies five instances where an individual's activity with respect to a farm will result in his not being treated as a limited partner or a limited entrepreneur. Generally, these cases involve situations where the farming interest is derived from an active trade or business, such as in the case of a retired farmer or a person who inherits an interest from an active or retired farmer, or any interest if it is owned by a farmer.⁵

Background

The provisions relating to farming syndicates and accrual accounting for farming corporations were enacted in 1976. As noted above, the effective date of the provisions concerning accrual accounting for farming corporations was postponed for one year for certain corporations controlled by two or three families.

The accrual accounting for farming corporations provision in the 1976 Act was based on the Ways and Means version of that Act. However, under this version, the only two exceptions were the subchapter S exception and a more stringent exception for family corporations than the one which was enacted. The latter exception in the Ways and Means version was generally based on the 66 $\frac{2}{3}$ -percent stock ownership by one family rather than the 50-percent ownership requirement.

The farming syndicate provision has not previously been considered by the Ways and Means Committee. It originated in the Senate's consideration of the 1976 Act and, coupled with an expanded at risk provision applicable to farming activities, was the Senate's substitute for the House-passed LAL (Limitation on Artificial Losses) approach to farming shelters.

⁵ More specifically, these cases cover situations where an individual—

(1) has an interest in the trade or business of farming which is attributable to his active participation in the management of the trade or business of farming for a period of not less than five years;

(2) lives on the farm on which the trade or business of farming is conducted (but only with respect to farming activities on such farm);

(3) actively participates in the management of the trade or business of farming which involves the raising of livestock (or is treated as being engaged in active management pursuant to one of the first two exceptions set forth above), and the trade or business of the partnership or other enterprise involves further processing of livestock raised in the trade or business with respect to which the individual in question (actually or constructively) is an active participant;

(4) actively participates, as his principal business activity, in the management of a trade or business of farming, regardless of whether he actively participates in the management of the activity in question; or

(5) is a member of the family (within the meaning of sec. 267(c)(4) of a grandparent of an individual who would be excepted under any of the first four cases listed above and his interest is attributable to the active participation of such an individual.

Administration Proposal

The Administration proposal would eliminate the family corporation exception to the required farm accrual accounting provision. The proposal would also extend the accrual accounting requirement to all farming syndicates, regardless of size, and would provide that State and local taxes other than real property taxes and income taxes would no longer be specifically excepted from treatment as preproductive period expenses.

Effective date

This provision would apply to taxable years beginning after December 31, 1978.

Revenue effect

It is estimated that this proposal would increase budget receipts by \$3 million for fiscal year 1979, by \$9 million for fiscal year 1980, by \$12 million for fiscal year 1981, and by \$13 million per year for fiscal years 1982 and 1983.

Member's Proposal

Mr. Tucker

The proposal would replace the current family corporation exception with an exception that would permit a corporation to continue to use the cash method of accounting if at least $\frac{2}{3}$ of the combined voting power of all classes of stock entitled to vote, and at least $\frac{2}{3}$ of the total number of shares of all other classes of stock, are owned by members of the same family, by officers, directors, or employees of the corporation, or by a trust for the benefit of employees of the corporation.

Issues

Accrual Accounting

A fundamental issue raised by this proposal is whether the cash method of accounting in farming is to be available for certain relatively large farming operations and farming syndicates.

The Treasury states that the administrative reason for allowing farmers to use the cash method of accounting was that farmers lack the financial resources and expertise necessary to utilize the accrual method of accounting, despite the fact that the latter method properly matches farming expenditures with related farming income. As a result, the cash receipts and disbursements method was permitted because of its greater simplicity. The Treasury contends that large farming corporations cannot claim that they lack access to the sophisticated accounting and record-keeping procedures involved in the accrual method of accounting. Also, most large companies already are required to keep financial records on an accrual basis in order to obtain certification of financial statements by an accountant. Treasury states that the 1976 Act did not go far enough in its application of the accrual accounting requirement. Under the "family corporation" exception, corporations with annual gross sales in excess of \$50 million can continue to use the cash method of accounting. Treasury states that a fundamental inequity of the 1976 Act is that the distinction between family and nonfamily corporations bears no relationship to the rationale of preserving simple bookkeeping methods for small farmers

who truly lack access to the necessary accounting and record-keeping procedures involved in the accrual method of accounting.

The Administration proposal would place large family-controlled farm corporations on the same tax accounting method as other large farming corporations. This should eliminate any income tax advantage between these large family farm operations and other large farming corporations which might arise by reason of the tax accounting rules. Since it may be argued that larger corporations have a competitive advantage because of their size over smaller farming operations, it does not appear to be as much of a competitive problem if small farm operations are given a tax accounting advantage over the large ones as to give some large operations a tax advantage over other operations of the same size.

Furthermore, Treasury contends that the rationale for cash accounting is inapplicable in instances where interests in farming operations are required to be registered with Federal or State securities officials, or where substantial portions of the enterprise are owned by passive investors, because the persons who are involved in farming as outside investors should not share in the cash accounting privilege designed for farmers unaccustomed to sophisticated financial transactions and recordkeeping. However, since the term farming syndicates includes any enterprise in which more than 35 percent of the losses are allocable to nonfamily passive investors, farming syndicates may be relatively small operations not necessarily involving sophisticated taxpayers.

Neither existing law nor the Administration proposal would require large proprietorships or partnerships (other than farming syndicates) to use an accrual method of accounting. Consequently, to the extent that there are large proprietorships or partnerships in farming, they would continue to have a tax advantage over farming corporations of the same size.

State and local taxes

Under present law, State and local sales taxes and personal property taxes are currently deductible regardless of whether such taxes are incurred in a trade or business, in connection with the production of income, or for personal purposes. Certain other miscellaneous taxes—such as transfer taxes—are deductible only if they are incurred in a trade or business or for the production of income. Also, these miscellaneous taxes may have to be inventoried or capitalized if they relate to inventory or to costs allocable to long-term contracts.

In its proposal relating to itemized deductions, the Administration has proposed allowing taxpayers to deduct State and local sales taxes and personal property taxes only if such taxes are incurred in a trade or business or in connection with the production of income. This proposal would also have the effect of making these taxes subject to the rules relating to the capitalizing of costs. The Administration proposal in regard to the definition of preproductive period expenses would be generally consistent with its proposal in the treatment of State and local sales taxes, personal property taxes, and miscellaneous taxes. (However, treatment of these taxes as preproductive period expenses appears to be inconsistent with the regulations relating to inventories, which permit the current expensing of these taxes rather than inclusion in inventory. Regs. § 1.471-11(c)(2)(iii)(a))

5. Deferred Annuities

Present Law

Under present law, tax on interest or other current earnings on a policyholder's investment in an annuity contract is deferred until amounts characterized as income are withdrawn or annuity payments are received (sec. 72(a)). Amounts paid under a contract before the annuity payments begin, such as policy dividends or payments upon partial surrender of a contract, are first treated as a return of the policyholder's capital and are taxable (as ordinary income) only after all of the policyholder's investment in the contract has been recovered (sec. 72(e)). A portion of each amount paid to a policyholder as an annuity is generally taxed as ordinary income (under an "exclusion ratio" test)¹ as are policy dividends paid after annuity payments begin.

A life insurance company which issues an annuity contract is not taxed on its investment income² to the extent that income is required to be added to its policyholder reserves for the annuity contract. (Secs. 802(b), 804(a), and 809(a).)

Background

General

A commercial annuity contract is a promise by a life insurance company to pay to the beneficiary a given sum for a specified period which may terminate at death. Annuity contracts permit the systematic liquidation of a fund consisting of principal and income. The insurance company, which guarantees payments of a given amount for a specified period, may take the risk that the fund will be exhausted before the company's liability under the contracts ends but may gain if its liability terminates before the fund is exhausted.

The starting date for annuity payments may be within one year after the initial premium is paid (an immediate annuity) or may be deferred to a later date (a deferred annuity). The period between the time the first premium is paid for an annuity and the time the first annuity payment is due is referred to as the "accumulation period."

¹ After annuity payments begin, each annuity payment received is generally allocated between ordinary income and excludible return of capital on the basis of the capital investment in the contract at the time annuity payments begin (the exclusion ratio). This allocation between income and capital continues for all of the annuity payments received by the policyholder even after all capital invested in the contract has been recovered tax-free. If the annuity terminates (for example, by reason of death) before capital is exhausted, no loss deduction is allowed. Under rules applicable to annuities under qualified pension plans, an employee's investment in the contract may be recovered first. (Sec. 72(e).)

² Capital gains are taxed to the insurance company unless the annuity is issued under a tax-qualified pension, profit-sharing, or stock bonus plan, an individual retirement annuity, or a tax-sheltered annuity, and the assets under such arrangements are held in segregated asset accounts that are not part of the general assets of the insurance company. (Sec. 801(g)(7).)

Annuity payments may be payable for a period which depends on the date of an individual's death (a life annuity) or they may be payable for a fixed period of time (a period certain annuity). A life annuity may be payable only for the life of an individual or it may guarantee payments for a specified minimum period (an annuity for a period certain and life thereafter).

An individual may purchase an annuity by payment of a single premium or may make periodic payments into a fund that will provide the annuity beginning on a specified date. A deferred annuity contract may, at the election of the investor, be surrendered before annuity payments begin, in exchange for the cash value of the contract. Partial surrenders are similarly permitted under some annuity contracts.

If either the premium paid for an annuity contract or the annuity benefits under the contract are based on the investment return and the market value of a separate fund established by the insurance company, the contract is a "variable annuity contract."

Investment annuities

Until 1977, the Internal Revenue Service treated an investment annuity as a type of variable annuity. Under an investment annuity contract, an investor could transfer an asset (typically a certificate of deposit in a bank or savings and loan association) to an insurance company. Under the contract, the asset was held in a custodial account and invested, or reinvested, pursuant to the taxpayer's control.³ The taxpayer could surrender (or partially surrender) the contract at any time before annuity benefits began and receive the amount held in the account (less any applicable charges).

The "wrap-around" annuity is generally the same as the investment annuity except that the policyholder does not retain control over the investment.

Under a 1965 private ruling and numerous subsequent rulings, the Service held that the usual rules for taxation of variable annuities applied to investment annuities. Accordingly, (1) income credited to invested assets was not taxed to the insurance company, (2) capital gains on invested assets were taxed to the insurance company unless the contract was held under a tax-qualified retirement arrangement (e.g., a contract under a qualified pension plan), and (3) an investor's tax on earnings on amounts invested under the contract was deferred until amounts were withdrawn or benefits were paid. Benefits paid under the contract were taxable as ordinary income after the investment in the contract was recovered.⁴

In 1975, the Service suspended the issuance of rulings as to investment annuities and, after public announcement of the suspension, held meetings with affected issuers. In 1977, after these discussions, the Service changed its position on the taxation of investment annuities. Under Rev. Rul. 77-85, earnings on assets first invested under an investment annuity contract after March 9, 1977 (the date the ruling was

³ The contracts typically limited investments to assets which could be readily liquidated, for example, savings deposits, listed securities, or mutual funds. Where appreciated assets are transferred under an investment annuity arrangement, the appreciation is subject to tax in the year of the transfer.

⁴ The exclusion ratio test applies in computing the income element of an annuity payment under an investment annuity arrangement.

released) are taxed to the investor currently, without deferral of the tax until benefits are paid under the contract.

Litigation over Rev. Rul. 77-85 has resulted in a District Court decision that the ruling was unreasonable and that the Internal Revenue Service had exceeded its statutory authority in issuing it. However, the decision has been appealed by the Service, and at this time the tax status of investment annuities is unresolved.

A Senate floor amendment to the Tax Reduction and Simplification Act of 1977 would have postponed the effective date of Rev. Rul. 77-85 until March 9, 1978. However, the amendment was not included in the legislation as enacted.

Treatment of annuity payments

The present law under which tax on the income earned on amounts invested in an annuity contract is deferred until it is paid dates back to 1918. Changes have been made by the Congress, however, in the rules for determining the portion of an annuity payment considered to be income. Prior to 1934, annuity policyholders were permitted to recover their entire investment in an annuity contract before any amount was includible in income. As part of the Revenue Act of 1934, the Congress adopted a rule under which 3 percent of each annuity payment was includible in income without regard to the investment in the contract. Finally, in 1954, the present exclusion ratio approach was adopted.

Administration Proposal

Under the Administration proposal, income earned during the accumulation period of a deferred annuity contract would generally be taxed to the contract holder in the year earned. However, this treatment would not apply to an annuity under a tax-qualified employee retirement plan, an individual retirement annuity, or a tax-sheltered annuity program for teachers or employees of public charities. Amounts taxed to a contract holder during the accumulation period would be added to the investment in the contract and would not be taxed again when the contract is surrendered or when annuity payments are received.

An individual would be permitted to designate a single deferred annuity contract, a "designated contract," the earnings on which would remain eligible for tax deferral during the accumulation period. The individual would be required to select the contract as a designated contract by so informing the issuer at the time of purchase. The designated contract would have to be separate from any other annuity contract held by the contract holder. Under the Administration proposal, existing contracts could be converted into designated contracts.

The maximum annual premium under a designated contract would be limited to \$1,000.⁵ In order for a contract to qualify as a designated

⁵The cash value of a contract yielding 7 percent annual interest would be \$13,816 one year after the last of 10 annual payments of \$1,000, and \$25,129 one year after the last of 15 such payments. It is estimated that a contract with a cash value of \$25,129 at the time an individual attains age 65 could provide an annual life annuity of approximately \$2,513 (10 percent of the cash value of the contract) beginning at that time. If the yield were at the rate of 8 percent annual interest, the contract would be worth \$14,586 one year after the last of 10 annual payments of \$1,060, and \$27,152 one year after the last of 15 such payments. (These computations do not take commissions or other applicable charges

contract, its value could not depend, in whole or in part, on the value of an underlying investment fund or segregated asset account. As a result, investment annuity contracts, wrap-around annuity contracts, or other variable annuity contracts could not be designated contracts).

Under the Administration proposal, in the case of any annuity contract (whether or not a designated contract) dividends which are not reinvested, withdrawals, and loans after December 31, 1978, would be treated as coming from accumulated and untaxed income and would be taxed until all such income is exhausted.

Under the Administration proposal, the issuer of a deferred annuity contract would be required to report annually to both the Internal Revenue Service and the contract holder on the amount of earnings with respect to the contract. In the case of a designated contract, the report would identify the earnings as excludable from income during the accumulation period.

Effective date

The Administration proposal would apply to a deferred annuity contract issued before February 1, 1978, only if the contract holder makes additional contributions to the contract after that date. Where additional contributions are made, earnings credited to the contract holder's account would be allocated between prior contributions and additional contributions. Only the earnings allocated to the additional contributions would be taxed currently.

Revenue effect

It is estimated that this proposal would increase calendar year 1979 liability by \$14 million, by \$30 million in 1980, \$48 million in 1981, \$72 million in 1982, and \$106 million in 1983.

Members' Proposals

Mr. Waggonner

As a substitute for the administration's proposals, distributions under a deferred annuity contract before the annuity starting date would be part income and part return of investment in the contract. Such distributions would not be eligible for income averaging; however, they would not be subject to a penalty tax.

Also, under this proposal, an investment annuity or a "wraparound" annuity would not receive annuity contract treatment. Further, any changes made to the carryover basis provisions would not apply to annuity contracts.

Mr. Gephardt

The cost recovery system of present law would be modified, and amounts received in the case of partial surrenders and withdrawals would be included in income under a pro rata approach.

The maximum annual premium permitted under a designated contract would be increased above \$1,000.

Mr. Conable

The tax treatment of investment annuity contracts and wraparound annuity contracts as it existed prior to the issuance Rev. Rul. 77-85 would be reinstated. Thus, these types of contracts would receive the same tax treatment accorded to traditional annuity contracts under present law.

Issues

The Administration proposal raises questions as to (1) whether tax deferral is appropriate under deferred annuity contracts, (2) whether limitations are needed where tax deferral is appropriate, and (3) to what extent tax should be deferred where funds accumulated under a deferred annuity contract are partially withdrawn (or used to secure a loan) before a retirement annuity is paid.

The Administration's proposal is based on the belief that the increase in sales of deferred annuities, which some sources estimate to have exceeded \$1 billion in 1977, reflects the promotion and sale of such contracts for their tax deferral features, features which are unavailable through other forms of savings other than life insurance.⁶ The Administration argues that where, as in the case of deferred annuity contracts, an investor may liquidate his investment at any time, tax on earnings from that investment should not be deferred.

Table 1 shows the advantage that tax deferral under annuity contracts has over current taxation of other investments. The table assumes that one taxpayer initially invests in a certificate of deposit issued by a savings institution which yields interest at an 8-percent annual rate, pays taxes on the interest each year, and reinvests the after-tax interest. The second taxpayer purchases a single-premium annuity contract providing an 8-percent annual rate of return, pays no taxes on the interest until the funds are withdrawn, and then pays taxes on the accumulated interest. The table shows how the amount of after-tax funds available to the two taxpayers depends on their tax bracket and the length of the accumulation period.

TABLE 1.—*Comparison of After-Tax Return per Dollar of Investment*

Length of period between investment and withdrawal (accumulation period)	Tax bracket: 30 percent		Tax bracket: 50 percent		Tax bracket: 70 percent	
	Investment vehicle:		Certificate	Annuity	Certificate	Annuity
	Certificate	Annuity				
5.....	\$0.31	\$0.33	\$0.22	\$0.23	\$0.13	\$0.14
10.....	.72	.81	.48	.58	.27	.35
15.....	1.26	1.52	.80	1.09	.43	.65
20.....	1.97	2.56	1.19	1.83	.61	1.10
25.....	2.90	4.09	1.67	2.92	.81	1.75
30.....	4.13	6.34	2.24	4.53	1.04	2.72
35.....	5.73	9.65	2.95	6.89	1.29	4.14

NOTE: Table assumes (1) 8-percent return for both certificate and single premium annuity, and (2) investors are in same tax bracket throughout entire period.

In all cases, the taxpayer who invested in the annuity contract has a greater after-tax return per dollar of investment than the taxpayer who invested in the savings certificate. In all tax brackets, the amount of the tax benefit of the annuity increases as the length of the accumulation period increases. For any particular accumulation period, the

⁶ Some of the promotional literature is cited in the "Detailed Explanation and Supporting Analyses," of the 1978 Tax Program, pp. 134-138.

relative advantage of the annuity is greater for taxpayers in higher brackets, but the amount of gain is not necessarily greater in higher brackets. These comparisons do not take account of commissions or other charges.

The Administration further believes that tax-favored retirement savings should be channelled primarily through the vehicles specifically provided by Congress, and that, if deferred annuities are to continue to be used for that purpose, they should be subject to limits.

Limitation on premiums

Deferral of tax on investment income has been provided by the Congress to encourage the accumulation of funds for retirement. For example, deferral is provided, for income earned under tax-qualified pension plans or individual retirement accounts. However, both tax-qualified plans and individual retirement accounts are subject to statutory limitations designed to restrict the amount that is entitled to special tax treatment.⁷

Similarly, although the Administration believes that it is appropriate to provide favorable tax treatment for the accumulation of funds for retirement, it also believes the amount that is entitled to this special treatment should be subject to dollar limitations. The Administration argues that the \$1,000 annual limitation on contributions should preclude the use of annuity contracts by high-income taxpayers as tax shelters and by self-employed persons as a means to avoid providing retirement benefits for their employees, while permitting the continued use of the traditional annuity contract to provide for retirement.

Others point out that a deduction is allowed for contributions to a qualified plan or an individual retirement account and, as a result, those arrangements provide the benefit of tax deferral on contributions as well as the benefit of tax deferral on earnings during the accumulation period. Thus, they believe dollar limitations are more appropriate in the case of qualified plans than they are in the case of deferred annuities (where a deduction has not been allowed).

Exclusion of variable annuities

The Administration proposal would limit tax deferral under annuity contracts to retirement-type contracts which guarantee repayment of principal and which do not depend on the investment return and the market value of a separate investment fund. Some believe that retirees are best served by such fixed income investments.

Others maintain that some portion of retirement income should be variable so that the retiree may benefit from the higher rates of return which may be available under variable annuities in times when equity values increase. They argue that there is no sound basis for distinguishing variable annuities from other annuities and restricting their use as retirement-income vehicles, and that such distinction unfairly discriminates against those companies that issue such contracts.

Withdrawals before annuity payments begin

The Administration proposal would treat amounts withdrawn from contract before annuity payments begin as income first rather than

⁷In addition, qualified plans may not discriminate in favor of employees who are officers, shareholders, or highly compensated.

principal. Where such payments are made, funds are available to pay tax and the tax should not be postponed. Others believe that the traditional treatment of pre-annuity payments provides flexibility that encourages retirement savings.

It has been pointed out by some that if policy loans are not treated as distributions of income under an annuity contract (until income is exhausted), rules treating other pre-annuity distributions as income could be easily circumvented. It has also been noted that pre-retirement borrowing against retirement income may reduce funds available during retirement. However, it has been argued that funds would not generally be withdrawn from a tax-favored deferred annuity contract unless they are needed for an important purpose and that these funds would not be available to pay the tax. It is also argued that if policy loans under an annuity contract are treated as income, additional borrowing may be required to pay the tax.

If the committee decides not to treat amounts withdrawn from a contract before annuity payments begin as income first rather than principal, it may wish to consider treating a pro rata portion of such withdrawals as income. This could be done through an exclusion ratio approach similar to that used currently for annuity payments.

It has been proposed that income averaging should not be available for withdrawals of income before annuity payments begin. Denial of income averaging would tend to reduce the tax advantage of deferral in some cases, but it has been suggested that the effect of the rule could be largely defeated if the payments are made over a period of 5 years and that a special rule for annuity contracts might add complexity to the 5-year income averaging rules.

Tax on income not withdrawn

Under the Administration proposal, income earned on deferred annuity contracts (other than designated contracts) would be subject to current taxation, as is the case with certificates of deposit and original issue discount bonds. As a result, some have noted that taxpayers with nondesignated contracts might have to partially liquidate their investments in the contracts to pay the tax or use other income or capital to pay tax each year on increasing amounts of investment income.

It has been suggested that another method of dealing with tax deferral under annuity contracts is to impose an additional tax only when income is withdrawn before annuity payments begin. The tax rate could be designed to approximate the additional value under the contract due to tax deferral. If the committee desires to continue tax deferral in the case of contracts used to provide retirement or disability income, the committee could provide that the additional tax would not apply to annuity payments or withdrawals on amount of disability.

Those who support the additional tax believe that it could roughly equalize the tax treatment of annuities not used for retirement with savings certificates. Others argue that because of varying load charges, income tax rates, and investment yields, the additional tax could be too high in some cases and too low in others. It is also argued that a lower rate should apply in the case of annual premium contracts than for single premium contracts. Some believe that the additional tax would tend to have its greatest impact on middle and lower in-

come taxpayers who are more likely to be required, by circumstance, to make withdrawals subject to the tax.

If the committee wishes to provide for an additional tax on income withdrawn from an annuity contract, the committee may wish to consider whether the amounts withdrawn should be considered to be capital first (as under present law), income first (as under the Administration proposal), or part-income and part-capital on a pro rata basis.

Simplification and administrability

The Administration proposal would require some additional reporting and recordkeeping and create additional compliance problems. In addition, the proposed transitional rules would create some complexity for existing contracts.

B. MINIMUM TAX PROPOSALS

Present Law

Present law (sec. 56 of the Code) provides a minimum tax on certain tax preferences of individuals and corporations. The minimum tax for individuals amounts to 15 percent of the sum of an individual's (or estate or trust's) tax preferences in excess of one-half of regular income taxes paid or, if greater, \$10,000.

The tax preference items included in this base of the minimum tax for individuals are:

- (1) Accelerated depreciation on real property in excess of straight-line depreciation;
- (2) Accelerated depreciation on personal property subject to a lease in excess of straight-line depreciation;
- (3) Amortization of certified pollution control facilities (the excess of 60-month amortization (sec. 169) over depreciation otherwise allowable (sec. 167));
- (4) Amortization of railroad rolling stock (the excess of 60-month amortization (sec. 184) over depreciation otherwise allowable (sec. 167));
- (5) Qualified stock options (the excess of the fair market value at time of exercise over the option price);
- (6) Percentage depletion in excess of the adjusted basis of the property;
- (7) The exclusion for long-term capital gains;
- (8) Amortization of child care facilities (the excess of 60-month amortization (sec. 188) over depreciation otherwise allowable (sec. 167));
- (9) Itemized deductions (other than medical and casualty loss deductions) in excess of 60 percent of adjusted gross income; and
- (10) Intangible drilling costs on oil and gas wells in excess of the amount amortizable with respect to those costs and, for 1977, in excess of net income from oil and gas production.¹

These items of tax preference also reduce, on a dollar-for-dollar basis, the amount of earned income eligible for the 50-percent maximum tax.

Background

Legislative history

The minimum tax was enacted in the Tax Reform Act of 1969. As enacted, the minimum tax rate was 10 percent, and a taxpayer could reduce preferences subject to the minimum tax by the full amount of regular tax liability plus a \$30,000 exemption.

In its consideration of the Tax Reform Act of 1976, the Ways and Means Committee approved a minimum tax rate of 14 percent, with an exemption from the tax of \$20,000 and an additional offset for one-

¹The Energy Tax Act of 1977, as passed by the House and the Senate, applies the net oil and gas production income offset rule, currently applicable only to 1977, to all subsequent years.

half of regular taxes paid. The \$20,000 exemption was to be phased out on a dollar-for-dollar basis so that individuals with preferences in excess of \$40,000 would have received no exemption. On the House floor, an amendment was adopted providing for the elimination of the entire deduction for regular taxes. The Senate approved a 15-percent minimum tax rate with an exemption equal to all of regular taxes paid, or, if greater, \$10,000. The bill as enacted reflects a compromise exemption of one-half of regular taxes paid or \$10,000.

Impact of minimum tax

For 1978, it is estimated that 355,000 individual taxpayers will pay some minimum tax. The revenue collected from these taxpayers is estimated at \$1.4 billion. As table 3 shows, over three-fourths of the revenue will be collected from 79,000 taxpayers with incomes in excess of \$100,000. However, 276,000 taxpayers with incomes below \$100,000 also will pay some amount of minimum tax.

Table 3.—Distribution of the Present Law Minimum Tax

[1978 income levels]

	Returns (thousands)	Amount (millions)	Percentage distribution
Expanded income class (thousands): ¹			
Below \$5.....	3	\$13	0.9%
\$5 to \$10.....	(²)	(²)	(²)
\$10 to \$15.....	1	1	0.1
\$15 to \$20.....	11	3	0.2
\$20 to \$30.....	30	14	1.0
\$30 to \$50.....	101	68	4.8
\$50 to \$100.....	131	236	16.7
\$100 to \$200.....	54	256	18.2
\$200 and over.....	25	818	58.1
Total.....	355	1,410	100.0

¹ Expanded income equals adjusted gross income plus minimum tax preferences less investment interest to the extent of investment income.

² Less than 500 returns, \$0.5 million, or 0.05 percent.

NOTE: Details may not add to totals because of rounding.

Although ten items of income or deduction are treated as preferences for individuals, the predominant preference item is capital gains, which accounts for approximately 76 percent of all tax preference amounts. Under present law, the maximum regular income tax on long-term capital gains of individuals is 35 percent. The impact of the minimum tax is generally to increase this maximum rate to 39.9 percent, although there are some isolated cases in which the combined minimum and regular tax rates equal 42.5 percent.²

² If the impact of the 50-percent maximum tax, under which preferences reduce the amount of the income eligible for maximum tax, is taken into account, the maximum tax rate on capital gains is generally 49.1 percent, although in a few isolated cases it can approach 52.5 percent.

Administration Proposal

Under the Administration proposal, the present exemption of one-half of regular taxes paid or \$10,000, whichever is greater, would be replaced with a flat \$10,000 exemption.

In addition, it is proposed that any capital gains resulting from the sale of a principal residence of an individual be exempted from preference treatment under the minimum tax.

Revenue effect

It is estimated that the Administration proposal would increase revenues by \$402 million for calendar 1979. There would be no revenue impact in fiscal year 1979 because the minimum tax is not reflected in withheld or estimated tax payments.

Members' Proposals

Mr. Stark

(a) The minimum tax rate would be increased from 15 percent to 20 percent.

(b) Oil and gas intangible drilling expenses would be subject to the minimum tax without any offset for oil or gas income.

Mr. Tucker

Capital gains would be eliminated as a preference under the minimum tax for individuals and corporations to the extent necessary to prevent the maximum tax rate for capital gains from being greater than one-half of the rate for ordinary income.

Mr. Archer

Intangible drilling costs would be eliminated as a preference under the minimum tax.

Mr. Steiger

Capital gains would be eliminated as a preference under the minimum tax for individuals and corporations.

Issues

Offset for regular taxes paid

Debate over the structure of the minimum tax has been characterized by a conflict between two different views of the purpose of the minimum tax. One view argues that the minimum tax should insure that every high-income taxpayer pays some minimum level of tax regardless of the composition of the taxpayer's income and deductions. Under this view, the minimum tax should be applied only to high-income taxpayers who have a low effective rate of regular tax (the so-called "alternative minimum tax"). The other general view is that the minimum tax should insure that some minimum amount of tax is paid on all items of preferential income and deductions by taxpayers who have substantial amounts of preferences. Under this view, the minimum tax should be imposed directly on items of tax preference above an exemption of a flat dollar amount (the so-called "add-on minimum tax").

The present minimum tax represents a compromise between these two viewpoints—by applying the tax directly on items but allowing a partial offset for regular taxes paid. The Administration proposal to eliminate any regular tax offset is based on the latter view that the

minimum tax should apply equally to all substantial users of tax preferences, regardless of their regular tax liability. This view was adopted by the House when it adopted a flat \$20,000 exemption with no regular tax offset in its consideration of the Tax Reform Act of 1976.

The primary argument in favor of the Administration's view is that whenever the exemption is based on regular taxes paid, the highest income individuals are able to pay a much lower minimum tax on equal amounts of preference income than are less affluent taxpayers. For example, under present law, a taxpayer with taxable income of \$200,000 pays a minimum tax of about \$3,000 on \$75,000 of tax preferences, while a taxpayer with \$75,000 of taxable income pays about \$9,000 in minimum tax on that amount of preferences. Under the Administration proposal, each taxpayer would pay a minimum tax of \$9,750 on \$75,000 of tax preferences.

On the other hand, it can be argued that it is appropriate for the minimum tax to take into account at least to some extent the amount of regular taxes paid by any taxpayer. In this way taxpayers who are already paying a substantial amount of income tax are not penalized (at least to the same extent) for utilizing tax preferences.

Table 4 shows that the revenue impact of eliminating the regular tax offset falls primarily on taxpayers with expanded incomes in excess of \$200,000.

Table 4.—Distribution of the Administration Proposed Minimum Tax Change¹ As Compared to Present Law

[1978 income levels]

	Returns with tax increase (thousands)	Amount of tax increase (millions)	Percentage distribution of tax increase
Expanded income class (thousands): ²			
Below \$5.....			
\$5 to \$10.....			
\$10 to \$15.....			
\$15 to \$20.....			
\$20 to \$30.....			
\$30 to \$50.....			
\$50 to \$100.....	13	\$3	0.8
\$100 to \$200.....	49	48	12.7
\$200 and over.....	32	326	86.5
Total.....	94	376	100.0

¹ Repeal the present law minimum tax offset for one-half Federal income taxes paid.

² Expanded income equals adjusted gross income plus minimum tax preference less investment interest to the extent of investment income.

To some extent the impact also falls more heavily on individuals with sizable capital gains preferences. This is the case because every

dollar of capital gain income results in 50 cents of preference income and 50 cents of income subject to regular taxes. Thus, any additional capital gains preference income results in some increase in the regular tax of the taxpayer, which in turn increases that taxpayer's exemption from the minimum tax (if the taxpayer uses the one-half of regular tax exemption).

If the committee decides to eliminate the offset for one-half of regular taxes paid, it might also consider increasing the flat dollar exemption level of the minimum tax. As discussed above, 355,000 taxpayers currently pay the minimum tax. (See table 3.) Increasing the exemption to \$15,000 would reduce the number of individuals subject to the minimum tax to 224,000, but would still result in a net revenue increase of \$155 million. Table 5 shows the distribution of increasing the flat dollar exemption to \$15,000 while eliminating the one-half of regular tax offset.

Table 5.—Distribution of Repealing the Tax Deduction From the Minimum Tax and Increasing the Floor to \$15,000 as Compared to Present Law

[1978 income levels]

	Tax decrease		Tax increase		Net tax change (million)
	Returns (thousands)	Amount (millions)	Returns (thousands)	Amount (millions)	
Expanded income class ¹ (thousands):					
Below \$5-----	3	\$2			-\$2
\$5 to \$10-----	(²)	(²)			(²)
\$10 to \$15-----	1	(²)			(²)
\$15 to \$20-----	11	2			-2
\$20 to \$30-----	30	12			-12
\$30 to \$50-----	101	48			-48
\$50 to \$100-----	130	82	1	(²)	-82
\$100 to \$200-----	34	19	26	\$20	1
\$200 and over-----	5	3	29	303	300
Total-----	314	167	56	323	155

¹ Expanded income equals adjusted gross income plus minimum tax preference less investment interest to the extent of investment income.

² Less than 500 returns or \$0.5 million.

NOTE.—Details may not add to totals because of rounding.

An increase in the flat dollar exemption to \$20,000 would reduce the number of taxpayers subject to the minimum tax to 157,000 and the overall revenue gain would be \$16 million. Table 6 shows the distribution of a flat \$20,000 exemption.

Table 6.—Distribution of Repealing the Tax Deduction Increasing the Floor to \$20,000 as Compared to Present Law

[1978 income levels]

	Tax decrease		Tax increase		Net tax change (millions)
	Returns (thousands)	Amount (millions)	Returns (thousands)	Amount (millions)	
Expanded income class ¹ (thousands):					
Below \$5.....	3	\$3			-\$3
\$5 to \$10.....	(²)	(²)			(²)
\$10 to \$15.....	1	(²)			(²)
\$15 to \$20.....	11	3			-3
\$20 to \$30.....	30	12			-12
\$30 to \$50.....	101	61			-61
\$50 to \$100.....	131	140			-140
\$100 to \$200.....	47	47	10	\$7	-40
\$200 and over.....	6	7	26	282	276
Total.....	329	273	36	289	16

¹ Expanded income equals adjusted gross income plus minimum tax preferences less investment interest to the extent of investment income.

² Less than 500 returns or \$0.5 million.

NOTE.—Details may not add to totals because of rounding.

In addition, the committee may desire to have the exemption phase out on a dollar-for-dollar basis. For example, a \$20,000 exemption, and no regular tax offset would result in a \$305 million revenue increase over present law. Such a phaseout, however, would increase the marginal tax rate applying to a preference to relatively high levels in the phaseout ranges. For example, with a dollar-for-dollar phaseout, additional preferences in the phaseout range would result in a minimum tax marginal rate of 30 percent. For preferences which are deferrals of tax, rather than outright exclusions, and on which regular tax is paid some time in the future, the total marginal tax rate could be quite high in certain cases.

Capital gains on principal residence

Two provisions of the Code currently permit homeowners to defer or to avoid paying a capital gains tax on sale of their principal residence. First, the so-called rollover provision (sec. 1034 of the Code) allows a deferral of any capital gains tax from the sale of a home where the gain is reinvested in a subsequent principal residence. A second provision is applicable to individuals age 65 and over (sec. 121) and exempts gain on sales of homes where the sales price is \$35,000 or less. When a sales price exceeds \$35,000, the exemption is for a fraction of the gain equal to \$35,000 divided by the sales price of the residence.

Given recent increases in housing prices, when homeowners wish to sell their homes and move into rental housing, many must pay a substantial capital gains tax and, in some cases, a significant amount of minimum tax even if the taxpayers' other income is relatively modest. These taxpayers are most likely to be older individuals who sell their home at or after retirement. An increase in the flat dollar exemption level would mitigate this problem. On the other hand, it has been argued that the minimum tax was never intended to apply in such a case and thus that these capital gains should not be subject to the minimum tax. Thus, the committee may want to consider removing capital gains from the sale of a principal residence as an item of tax preference.

Simplification and administrative aspect

By eliminating the one-half of regular tax alternative exemption, it can be argued that the minimum tax is simplified because taxpayers will not have to determine which alternative exemption is more advantageous. However, it would result in some increase in the number of taxpayers subject to the minimum tax. Of course, increasing the flat dollar exemption at the same time could result in a substantial decrease in the number of taxpayers subject to the minimum tax thereby accomplishing a significant simplification for these taxpayers.

From the standpoint of simplification the best change would probably be to eliminate the minimum tax entirely and make comparable adjustments to the tax preferences themselves in order to raise approximately the same amount of revenue from each preference. However, "cashing out" the minimum tax in this way would mean that the reduction in the value of the tax preferences would apply to all users of those preferences, not just those whose preferences exceed the exemption level.

