REPORT #515

# TAX SECTION

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February 19, 1986

FEDERAL EXPRESS

The Honorable Dan Rostenkowski
2232 Rayburn Building
Washington, DC 20515

Dear Representative Rostenkowski:

Enclosed is a report of the Special Committee of the New York State Bar Association Tax Section on Effective Dates of H.R. 3838.

The report strongly recommends deferral of many effective dates although recognizing that, in some instances, an early effective date may be appropriate.

I hope the report proves useful to you in considering H.R. 3838 effective dates.

Sincerely,

Richard G. Cohen

RGC:jl
Enclosures
cc: The Hon. John J. Duncan )with
Robert J. Leonard, Esq. )enclosure

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February 19, 1986

FEDERAL EXPRESS

The Honorable Bob Packwood
Chairman
Senate Finance Committee
259 Russell
Senate Office Building
Washington, DC 20510

Dear Senator Packwood:

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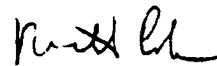
The report strongly recommends deferral of many effective dates although recognizing that, in some instances, an early effective date may be appropriate.

I hope the report proves useful to you in considering H.R. 3838 effective dates.

Sincerely,



Richard G. Cohen

RGC:jl
Enclosures
cc: The Hon. Russell B. Long )with
John Colvin, Esq. )enclosure

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February 19, 1986

FEDERAL EXPRESS

The Honorable David H. Brockway
Chief of Staff
1015 Longworth Building
Washington, DC

Dear Dave:

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Sincerely,

Richard G. Cohen

RGC:jl
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February 19, 1986

FEDERAL EXPRESS

J. Roger Mentz, Esq.
Acting Assistant Secretary
United States Treasury
15th & Pennsylvania Ave., NW
Room 3108
Washington, DC 20220

Dear Roger:

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# NEW YORK STATE BAR ASSOCIATION
# TAX SECTION

## EFFECTIVE DATES OF TAX REFORM LEGISLATION[1]

Congress is currently considering tax reform legislation that would have an impact on many areas of the country's economy. The House of Representatives has passed the Tax Reform Bill of 1985 (H.R. 3838, referred to below as the "Bill") and the Senate Finance Committee is now considering similar legislation. Many of the Bill's provisions would take effect on January 1, 1986, or on earlier dates, thus raising the possibility that provisions of this legislation when finally enacted will take effect before the date on which the legislation is enacted.

The uncertainty about the effective dates of the pending legislation has made it difficult for taxpayers and their advisors to plan transactions. This report discusses general principles that should govern the effective dates for tax legislation and describes how those principles should apply to selected provisions of the Bill.

In numerous prior reports, the Executive Committee of the Tax Section has taken the position that, with very limited

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[1] This report was prepared by Peter L. Faber, Dale S. Collinson, and Herbert L. Camp. Helpful written comments were received from Eric J. Anderson, Matthew E. Brady, William L. Burke, Bennett D. Cohen, Richard G. Cohen, William M. Colby, John A. Corry, Alan W. Granwell, Robert A. Jacobs, Sherman F. Levey, Robert J. Levinsohn, Richard O. Loengard, Bruce M. Montgomerie, Elliot Pisem, Laraine S. Rothenberg, Donald Schapiro and Michelle P. Scott.

exceptions, tax legislation should not be enacted with retroactive effect.[2] We reaffirm that position in this report. The term "retroactive" is value loaded, but its meaning may be ambiguous. Clearly legislation is retroactive if it governs the determination of tax liability for periods before the date when it is announced or proposed. The effective dates in the Bill do not involve that kind of retroactivity. In this report, a reference to "retroactive" effective dates or "retroactivity" relates only to the application of changes in the tax laws to transactions or periods before the date of enactment of the legislation.

## I. General Principles

### 1. Effective dates.

The principal reason for enacting tax legislation prospectively is that fairness dictates that taxpayers should be able to plan transactions with the assurance that the law that purports to be in effect when the transactions are accomplished is the law that will apply to them. Although certainty in planning transactions is often prevented by ambiguity in the law, this is a necessary consequence of a complex society that requires complex laws for its governance. The uncertainty

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[2] See, e.g., New York State Bar Association Tax Section, Committee on Tax Policy, "Retroactivity of Tax Legislation," 29 Tax Lawyer 21 (1975).

should not be compounded by the possibility that the Congress will retroactively change the ground rules applicable to a pattern of behavior. It has been argued that the reliance argument is circular and says nothing more than that people should be able to rely on present law because they have been able to rely on present law not being changed retroactively in the past.[3] While this argument may be logical, it ignores the reasons for the past practice and, hence, is irrelevant to a debate as to what the policy governing effective dates should be. The problem is that taxpayers clearly cannot rely on a proposed law; if they cannot rely on present law, their legal position is completely uncertain.

A further disadvantage of retroactive tax legislation is the paralysis that can result from public awareness that a proposed piece of legislation may be retroactive. At the present time, for example, the issuance of many types of tax-exempt bonds has been brought to a halt because of the uncertainty as to whether certain provisions of the Bill will apply to tax-exempt bonds issued after December 31, 1985. Although the Bill has specific effective dates for these provisions, there have been indications that these effective dates may be postponed and resolutions adopted by both the House and the Senate in December 1985 stated that tax reform

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[3] Graetz, "Retroactivity Revisited," 98 Harvard Law Review 1820, 1823 (1985).

legislation should generally be effective no earlier than January 1, 1987. Since it seems likely that final legislation will not be enacted, if at all, until the summer, the precise form of that legislation and its effective dates may not be known for some time. It will therefore not be possible to determine beforehand the tax consequences of any transactions done during the first half of 1986. This uncertainty may prevent legitimate transactions from going forward.

Indeed, at the present time taxpayers face two sources of uncertainty. The first concerns what the substantive provisions of tax reform legislation will be; the second concerns what the effective dates will be. It is important that any decisions to postpone effective dates for all or a portion of the Bill be made and announced promptly in an authoritative way, such as an announcement of the chairmen and ranking minority members of the House Ways and Means Committee and the Senate Finance Committee, with the concurrence of the Secretary of the Treasury.

Even if taxpayers proceed with transactions, uncertainty regarding the tax treatment of those transactions creates inefficiency in pricing and resource allocations. For example, equipment lessors may demand a higher return to hedge against tax uncertainty, or the risk of tax changes may be thrown on the lessee through a complicated, and separately negotiated, tax adjustment clause. Given the reality that tax

changes are under consideration by Congress more often than not, the inefficiencies created by tax uncertainty may seriously undercut the goal of securing a more productive allocation of resources through improved capital cost recovery allowances.

Finally, it may be desirable with respect to particularly complicated or massive tax revisions to defer effective dates until after the date of enactment to give time for needed technical corrections. The 1981, 1982 and 1984 Acts have been followed by extensive technical corrections legislation, and even more technical corrections are likely to be needed for the current legislation.

Retroactivity may be justified in some circumstances. Examples would include the correction of generally acknowledged drafting errors, changes that do not adversely affect taxpayers, and the correction of clearly abusive situations that Congress never intended to permit.

It has been suggested that a failure to make some changes retroactive may increase activity that the changes are intended to discourage. For example, the announcement that legislation correcting an abusive tax shelter will be effective at a future date may increase investments in the shelter as taxpayers rush to make their investments before its use is barred. Ths risk that an acceleration of undesirable conduct will be caused by a prospective effective date should be evaluated in individual cases. The resolution of the problem

will depend on the expected acceleration of the activity, the revenue that might be lost thereby, and the extent to which people taking part in the activity can be expected to know of the effective date.

Retroactivity may also be justified when the economic effect of the change is minor and decisions are unlikely to be affected by the change. For example, it is unlikely that minor changes in the calculation of the alternative minimum tax would affect taxpayer decisions as to whether to enter into a particular investment, and there would seem to be no reason why such changes should not be retroactive. On the other hand, a major change in the calculation of the alternative minimum tax, such as that set forth in the Bill, could affect taxpayer decisions as to whether to enter into particular transactions, and it is arguable that those changes should apply only to transactions entered into in the future.

Retroactivity has sometimes been justified by pointing to the need to avoid revenue losses that could result from delayed effective dates. We do not believe that retroactivity can be justified on this ground. Taxpayers should not be subjected to the uncertainty and unfairness resulting from having the ground rules for their transactions changed retroactively just because the Government wishes to raise more money. The proper way to increase revenues is to increase tax

rates, not to change substantive rules on which taxpayers have relied.

One factor that could justify retroactivity in the present environment is that the tax reform proposals announced by the Treasury Department in November 1984, on which much of the Bill is based, bore a January 1, 1986 effective date. Thus, taxpayers had been on notice for well over a year that major tax changes were proposed to become effective on that date and, indeed, we are aware of transactions that were planned and closed in 1985 because of the taxpayers' awareness that changes might be effective on January 1, 1986. On the other hand, it now seems clear that any legislation enacted by Congress this year will be different in major respects from the Treasury's 1984 proposals. It also became apparent in late 1985 that legislation would not be finally enacted until well into 1986 and, because of the uncertainty as to the form that such legislation might take, many taxpayers assumed that the effective dates initially announced by the Treasury would be deferred. This expectation was given added weight by the resolutions adopted by the House and Senate late in 1985 indicating that in general tax reform legislation should not become effective until January 1, 1987. Moreover, although the principles of the Treasury proposals had been announced in 1984, legislative language was not proposed until late in 1985, and

past experience has shown that general principles can change drastically when they are reduced to statutory language.

A further problem with retroactive tax legislation is that, the political process being what it is, it is likely that Congress will be convinced in particular cases that some form of transitional relief is appropriate. Taxpayers with access to Congressional staffs are more likely to get transitional relief than are others. Transitional rules are often highly individualized to the point that it is obvious that they were inserted for one particular taxpayer.[4] This phenomenon inevitably breeds disrespect for the legislative process and its product, which in turn may contribute to compliance problems.

For obvious reasons, changes in tax rates are applied retroactively in the sense that the new rates apply to all income, including income from existing investments acquired before the changes in tax rates. It would be administratively impossible to exempt all prior transactions from the effect of rate changes. Taxpayers have come to regard rate changes as one of the risks that one assumes in entering into business and investment transactions. Moreover, rate changes affect everyone and do not single out particular groups of transactions.

Determining when a change should be treated as a tax rate adjustment is not always clear. The Bill, for example,

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[4] See, e.g., Bill § 203(d)(5).

would extend the alternative minimum tax to losses from certain passive investments. Many persons who had invested in limited partnerships that produced tax losses before this change was first announced in the options presented by ths Joint Committee on Taxation staff to the House Ways and Means Committee in the fall of 1985 would find, if this became law, that the economic projections on which their investments had been based would be drastically changed. Although one can argue that the extension of the alternative minimum tax to losses of this type represents nothing more than an increase in the tax rate on income from such investments, it seems more accurate to say that the change would involve the computation of the tax base for the alternative minimum tax and that investments that had been entered into before the change should be given transitional relief. Similarly, the disallowance of interest deductions or foreign tax credits with respect to certain loans would also seem to be a change respecting the tax base that should be entitled to transitional relief.

Legislation is sometimes made effective on the date on which proposals are announced by the Treasury Department or are adopted by a Congressional committee. The rationale for this approach is that taxpayers who are apprised of the possibility of change should not be entitled to assume that the law will remain the same. This argument assumes that information about proposed changes is instantly communicated to taxpayers and

their advisors throughout the country. While it may be that tax practitioners in Washington may have immediate access to announcements of proposed changes, this is not true for the vast majority of tax practitioners and taxpayers around the country. The problem is aggravated when, as is often the case, many proposed changes are announced at the same time. Experience has shown that it takes anywhere from two days to two weeks for most people in the tax community to learn of proposed changes. For example, we have received printed brochures from brokers soliciting early 1986 contributions to IRAs that do not caution that individuals participating in section 401(k) plans may be ineligible to make IRA contributions; we assume that literally thousands of taxpayers have made such contributions, which will have to be withdrawn if the January 1, 1986 effective date of the Bill is not postponed.

We believe that it is inappropriate for changes generally to be effective as of the dates on which proposed changes are announced. There is never any certainty that an announced change will in fact take effect. Taxpayers should not be placed in a position in which the law applicable to a transaction is uncertain on ths date on which the transaction occurs. Effective dates keyed to announcements of proposed legislation can paralyze economic activity with undesirable social and economic consequences. If changes must be keyed to announcement dates, they should take effect as of a designated

date no earlier than two weeks after the announcement, except when the change is intended to correct obvious abuses that had not initially been intended by Congress.

2. Transitional rules.

Regardless of the approach adopted with respect to retroactivity, we believe that certain general principles should be applied with respect to transitional rules. Highly particularized transitional rules are unfair and, more importantly, create the appearance of unfairness to other taxpayers. Transitional rules should be general in nature and should be designed to apply to classes of taxpayers.

At what stage in a transaction are the parties so committed to a course of conduct that transitional relief is justified? The answer to this question will depend on the type of transaction. Ordinarily it would seem that parties should not be entitled to transitional relief unless they have made a binding commitment to a course of conduct before the effective date. On the other hand, some transactions involve massive expenditures of time and money before the parties reach a point at which they are legally bound, and it would seem fair to allow transactions of this type a grace period in order to enable them to be completed.

The scope of the activity eligible for transitional relief should be determined with some care. In the past, changes have often been made with respect to particular

activities without regard to whether other activities were integrally related with.them. For example, if a manufacturing corporation builds a new plant and places it in service by the effective date of legislation changing the depreciation rules although not all of the machinery needed for the plant's full operation is in place on that date, it would seem reasonable to provide that the old depreciation rules would apply to machinery that is part of the same integrated project if it is placed in service within a reasonable period after the effective date. On the other hand, if a builder decides to build five separate apartment buildings but they are not essentially related through financing, contiguity or otherwise, the application of new depreciation rules should be determined separately with respect to each project.

The form of transitional relief may vary from case-to-case. Although transitional relief usually involves complete exemption of transactions occurring before the effective date, phasing in a change should be considered. This approach is taken for the disallowance of interest deductions in the Bill and for the disallowance of excess credits on certain foreign loans. A phase in may be appropriate for cases in which the effect of a change is spread over many years. One candidate for this treatment might be the proposed extension of the alternative minimum tax to losses from certain passive investments.

3. Illustrative case; repeal of General Utilities doctrine, (a) background.

The foregoing principles may be illustrated by a more extended discussion of the proposal to repeal the General Utilities doctrine. The Bill would repeal the so-called General Utilities rule and would require corporations to recognize full gain or loss from sales or distributions in a corporate liquidation, with a limited exception for "qualified shareholders" (see below). This required recognition treatment would apply to sales and distributions occurring on or after November 20, 1985 (the date of Ways and Means Committee action), with exceptions for section 338 elections for qualifying stock acquisitions completed before November 20, 1985 and for sales or distributions made pursuant to a plan of liquidation adopted before November 20, 1985.

The repeal of existing Code sections 336(a) and 337(a) formed no part of the "Treasury I" and "Treasury II" tax reform proposals or the Ways and Means Committee's tax reform outline[5] (the so-called "Rostenkowski" plan). Nevertheless, as the Ways and Means Committee neared completion of its work on the Bill, it issued a statement indicating that the Bill would contain such a provision, without however indicating what the effective

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[5] STAFF OF THE JOINT COMM. ON TAXATION, TAX REFORM PROPOSALS IN CONNECTION WITH COMMITTEE ON WAYS AND MEANS MARKUP (September 26, 1985), reprinted in Bulletin 42 EXTRA, Section 1, Fed. Taxes (P-H) (September 30, 1985).

date would be.[6] Despite prior statements by Administration and congressional leaders that the provisions of the bill would not have effect before January 1, 1986,[7] the provision was ultimately proposed to be retroactive to November 20, 1985.[8]

(b) transitional rule interpretative problems. In an effort to mitigate the harshness of the proposed early effective date, section 335(b)(1) of the Bill provides that the repeal of existing Code sections 336 and 337 will not apply to a plan of liquidation adopted before November 20, 1985. Section 335(b)(2) and (3) then adds a series of "special rules" intended "to provide relief in situations in which a decision to liquidate

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[6] Ways & Means Compromises on Oil Preferences, 85 Tax Notes Today 229-3 (November 21, 1985) (reporting November 20 Committee action adopting repeal of General Utilities doctrine in order to make up for revenue loss from oil and gas preference compromise).

[7] See, e.g., Packwood, Rostenkowski Issue Statement on Effective Dates of Tax Reform Plans, 85 Tax Notes Today 55-3 (March 18, 1985) ("[I]n general, no changes would be effective before January 1, 1986."); Baker Presents Principles of Fundamental Tax Reform; Pushes Treasury Proposal Effective Dates to Jan. 1, 1986, 85 Tax Notes Today 43-5 (February 28, 1985) (statement by Treasury Secretary that "no administration tax reform proposal will contain an effective date earlier than January 1, 1986.").

[8] The repeal of the General Utilities doctrine was part of the comprehensive overhaul of subchapter C of the Code proposed by the Senate Finance Committee staff. STAFF OF SENATE COMM. ON FINANCE, S. PRT. 47, 99th Cong., 1st Sess., Final Report on Subchapter C (Comm. Print 1985). However, these proposals had not been part of the present reform effort and were publicly released for study only. In any case, the Senate proposals would have been of prospective effect only, applying to transactions pursuant to plans of liquidation adopted after December 31, 1985.

has clearly been made."[9] These provisions are an attempt to avoid restricting relief to the class of taxpayers who had adopted formal plans of liquidation prior to November 20, 1985 and, instead, to allow any corporation which had earlier decided to liquidate to be governed by existing law.

The parameters of these novel concepts are not always clear. For example, Bill section 335(b)(2)(A)(ii) applies when "the shareholders or board of directors have approved [a transaction described in Code section 336 or 337]" before November 20, 1985. The Bill does not adequately define "approval" and the legislative history states only that approval will be "deemed" to have occurred if there was, before November 20, 1985, "sufficient written evidence to establish that a decision to liquidate has been approved."[10]

Section 335 (b)(2)(B) of the Bill provides that transactions shall be treated as made pursuant to a plan of liquidation adopted before November 20, 1985 if before that date there had been an offer to purchase a majority of the voting stock of the liquidating corporation or that corporation's board of directors had approved an acquisition or recommended its approval to its shareholders. However, a non-binding offer that has not been accepted by the target corporation's board of

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[9] H.R. Rep. No. 426, 99th Cong., 1st Sess. 288 (1985).

[10] Id. at 288-89.

directors will not qualify. This transition rule applies only if "the [liquidating] sale or distribution is pursuant to or was contemplated by the terms of the offer or resolution." This rule protects situations where significant steps had been taken toward an acquisition, while limiting that relief to essentially the same transaction. The limitation seems undesirable. Once a company has been put up for sale and has received a bid, it should be able to solicit competing bids without such subsequent bids being burdened with tax disadvantages. In any event, the approach taken in the transitional rule invites confusion, which is evident in the accompanying explanation in the report of the Ways and Means Committee. Acquisition proposals do not necessarily address the acquiring company's intention to make a section 338 election or to liquidate the acquired company, and the deemed sales and liquidation pursuant to a section 338 election would generally remain the same despite substantial changes in the acquisition transition. The transitional rule should focus on whether the acquisition, not the liquidating sale or distribution, is pursuant to or contemplated by the terms of the offer or resolution.

(c) imperfections in 10% shareholder exception. Under Code section 336(c), as proposed to be amended by section 331(a) of the Bill, a special rule would be provided to mitigate the effects of the new legislation in the case of the liquidation of certain corporations in which one (or more) individual(s) has

owned at least 10% of the stock for a specified minimum period ("qualified stock"). Under this rule, nonrecognition of gain or loss with respect to certain assets would continue to apply to the extent of the "applicable percentage," i.e., the percentage (by value) of the qualified stock of the corporation owned by such 10% individual shareholders on the date of the adoption of the plan of liquidation. The Bill would require this stock to be owned directly by noncorporate shareholders on the date of adoption of the plan; stock beneficially owned by a 10% individual shareholder through a holding company would, pro tanto, not qualify for section 336(c) relief. This rule penalizes arrangements which may have been made for sound business reasons; nonresident aliens, for example, often interpose a corporation incorporated in their country of residence in the corporate structure. Moreover, a corporation with such corporate shareholders may avoid the rule by rearranging its stock ownership before adoption of a plan of liquidation. During the transitional period before enactment of the Bill, such a rearrangement of stock ownership may be undertaken merely as an insurance policy to take advantage of proposed Code section 336(c), if it is enacted.

However, it is likely that section 336(c) will be modified. In a situation where qualifying 10% or greater shareholders own less than 100% of the stock, the relief provided by section 336(c) benefits all shareholders (because

the relief is provided at the corporate and not the shareholder level) and not just the 10% or greater shareholders. For example, if qualifying shareholders own 30% of the stock, 30% of the corporate gain would escape tax, but the qualifying shareholders would receive only 30% of the accompanying tax benefits. We understand that Congressional and Treasury staff are aware of this anomaly and will seek to correct it.

(d) recommendations. We would urge a nonretroactive effective date for the repeal of General Utilities. It is clear that the provisions repealing General Utilities are controversial and are likely to be changed in the Senate. For example, it seems generally agreed that the relief provision applicable if "qualified stock" is outstanding should be amended so that its benefits are better targeted. It seems clearly wrong to enact legislation retroactively when (i) its details are not yet established and (ii) the exemption from tax which is to be repealed has long been recognized and accepted as part of the Code.

Hence, assuming enactment of the Bill in 1986, we would recommend that the repeal become effective on January 1, 1987. It would therefore not apply to liquidating sales or distributions or to elections under section 338 of the Code which took place or were effective as of any date prior to 1987. The date of adoption of a plan of liquidation would not be significant; if a plan was adopted in 1986 but the sale or

liquidation distribution took place in 1987 (or thereafter), the repeal provision would apply to such sale or distribution. An alternative rule would extend relief to sales or distributions pursuant to a plan of liquidation adopted in 1986 and to section 338 elections with respect to qualifying stock purchases occurring in 1986, but any such relief should not extend to sales or liquidation distributions made after December 31, 1987.

To the extent that there is a special concern regarding the liquidation of publicly-held corporations that continue essentially the same business, management and equity ownership through a different form of tax entity, such as a publicly-held master limited partnership, a special rule applying an earlier effective date to such liquidations could be crafted.

Finally, we are concerned that if the repeal of General Utilities is applied, in general, retroactively, exceptions will be made for specified transactions by taxpayers who have sympathetic cases, particularly in view of the inadequacies of the Bill's transition rules. To postpone the effective date for certain select taxpayers in this fashion would encourage a skeptical attitude toward the fairness of the tax law and thus defeat one of the principal goals of tax reform.

## II. Application of Principles

### A. Individual Income Tax Provisions

Title I of the Bill deals generally with income tax provisions affecting individuals. Principally, that title would

reduce the marginal tax rates applicable to individuals, increase the standard deduction and personal exemptions, amend provisions relating to certain exclusions from income and deductions, and make other miscellaneous changes (including the repeal of income averaging). At the same time, section 241 of the Bill would reduce the deduction for long-term capital gains to 42 percent, leaving such gains taxable at a maximum rate of 22 percent. Also, the Bill would restrict the deductibility of certain expenses for meals, travel, and entertainment.

Under Section 151(a) of the Bill, the provisions of Title I, including the provisions affecting expenses for meals, travel, and entertainment, would generally apply to taxable years beginning after December 31, 1985. Thus, the new rate structure would affect most individuals in the current taxable year. Section 122(a) of the Bill, which makes unemployment compensation taxable to the recipient, would apply only with respect to payments received after December 31, 1986 in taxable years ending after that date; amendments regarding the tax treatment of certain scholarships are to apply to scholarships granted after September 25, 1985; amendments affecting parsonage and military housing allowances would apply to taxable years "beginning before, on, or after, December 31, 1985."

With respect to changes in tax rates, there seems to be no persuasive argument favoring any one effective date over another. The concomitant provisions making changes in the

taxable base (including, for example, the provision involving an individual's deduction with respect to long-term capital gains) should in most cases have the same effective date. The intent of the provision regarding scholarship grants is presumably to prevent a rush of grants before the general effective date of the Bill; we believe that that concern is valid and that that effective date provision should remain in its current form. We believe, however, that the provisions affecting expenses for meals, travel, and entertainment should take effect only for taxable years following enactment of the Bill. The Bill would make significant changes in the deductibility of such expenses, and we believe that it is appropriate to defer the effective dates of those provisions.

B. Capital Income Provisions

1. Depreciation and investment tax credit. In general, the Bill's changes apply to all property placed in service after December 31, 1985, with an exception for property constructed, reconstructed, or acquired pursuant to a written contract that was binding on September 25, 1985, and at all times thereafter and with numerous other transitional rules.

Past changes in depreciation rules and the investment tax credit have frequently been given immediate effective dates with similar transition rules. See section 49, before repeal by Public Law 95-600. Moreover, the Administration's proposed changes included the December 31, 1985 effective date and

businesses have, therefore, had ample notice that capital cost recovery allowances would most probably be made less generous.

The precise nature of the new capital cost recovery allowance system is not clear at the present time because the President has indicated that more generous provisions than those contained in the Bill are a prerequisite of an acceptable bill. Largely because of this uncertainty, the Bill's retroactive effective date of January 1, 1986 applicable to these provisions has, in our experience, already caused deferral of capital investment at the outset of what is threatening to be a prolonged period of legislative deliberation. Businesses which are choosing to proceed with investments are doing so with no assurance as to the true cost of their acquisitions. We note that the vast bulk of the affected transactions are commercially customary and non-abusive; the proposed changes represent a shift in the extent to which the tax laws will be used to encourage capital formation, not the correction of an abuse.

To minimize the foregoing problems of investment deferral and business uncertainty, it is recommended that the foregoing changes have an effective date of January 1, 1987 or, if later, the enactment date of such changes. The general transitional rules currently included in the Bill should be retained but appropriately modified to reflect the recommended effective date. The detailed transitional rules that seem

designed to protect particular taxpayers would no longer be necessary.

2. Oil, Gas and Hard Minerals. Section 251(a) of the Bill would limit the deductibility of certain intangible drilling and development costs, and would allow taxpayers to amortize over a 26-month period any costs not currently deductible. The Bill would phase out percentage depletion for oil and gas wells and geothermal deposits over a three-year period and would disallow percentage depletion with respect to lease bonuses, advance payments, and other similar payments. The Bill would repeal section 631(c) of the Code, which relates to disposal of coal or domestic iron ore with a retained economic interest. Finally, the Bill would reduce the hard mineral percentage depletion rates and reduce the 50 percent net income limitation to 25 percent.

The drilling cost provision would apply to costs paid or incurred after December 31, 1985 in taxable years ending after that date; the phase-out of percentage depletion would begin for production during calendar 1986. The denial of percentage depletion for lease bonuses would take effect on January 1, 1986. The hard mineral depletion changes are fully effective for 1988 production and are phased in for production in 1986 and 1987.

The proposed changes in the treatment of intangible drilling costs and percentage depletion seek to remove tax incentives where Congress believed them unnecessary; apparently, there is no specific abuse that the changes redress. Taxpayers may have premised decisions on the availability of such incentives. Accordingly, we believe that the proposed rules should take effect (and phase-in treatment should begin) following, or, better, in the taxable year beginning after the year of enactment of the Bill.

C. Proposed Corporate Changes

1. Rates, capital gains, dividend deduction. Section 301 of the Bill reduces the maximum corporate tax rate to 36 percent. Section 302 would terminate corporate capital gains treatment, subjecting all corporate income to tax at the maximum rate. A dividends-paid deduction would be available only for 80 percent of dividends to corporate shareholders, gradually decreasing to 70 percent in 1997; a ten percent dividends paid deduction would be available to payors of dividends.

The rate reduction would take effect in taxable years beginning after July 1, 1986. The elimination of capital gains treatment, however, would apply to all income arising after December 31, 1985, unless the gain is attributable to a sale or exchange either occurring on or before September 25, 1985, or pursuant to a binding contract in effect on that date. Under section 15 of the Code, the maximum corporate tax rate during

1986 would be 41 percent; but under Code section 1202 as revised, the 1986 capital gains rate is 36 percent. The dividends-paid deduction would phase in beginning in 1987, escalating to 10 percent by 1996. Similarly, the phase-in period for the reduced dividends-received deduction would begin in 1987, and end in 1996.

As with the individual provisions, we recommend no particular date as the effective date for changes relating to corporate tax rates. There is no justification, however, for delaying the effective date of the rate changes until six months after the repeal of special corporate capital gains treatment. We recommend that those two provisions take effect at the same time, along with the other provisions relating to corporate income.

2. Net operating loss carryovers. Section 321(e)(1) of the Bill generally provides that the proposed new version of section 382, which limits net operating loss carryovers in certain acquisitions, will apply to a "50-percent owner shift" (presumably, this should read "more than 50-percent owner shift") where the "trigger day" occurs after December 31, 1985 and, further, that for purposes of determining whether there is a more than 50-percent owner shift after December 31, 1985, the "testing period" shall not begin before October 28, 1985.

The inclusion of a January 1, 1986 effective date in the Bill, coupled with the failure to enact legislation at the

end of 1985 to postpone the effective date for the 1976 version of section 382, has created a confusing situation for investors, since any one of three competing versions of section 382 may ultimately be made applicable to 1986 transactions: section 382 as in effect before January 1, 1986 (1985 section 382), section 382 in the form enacted in 1976 (1976 section 382) and the proposed section 382 incorporated in H.R. 3838 (new section 382). In fact, the final legislation could include a new variation.

In our view new section 382 should not become effective until 1987; we reach this conclusion because the complexity of the proposal and the likelihood that it will be amended in the Senate makes it almost impossible for taxpayers to plan transactions during Senate consideration of H.R. 3838. While it would be possible to make the provision applicable to transactions after the date of enactment, the complexity of new section 382 and the uncertainty as to its precise form when enacted makes it desirable to give taxpayers and their representatives some time to study these provisions before they become effective. Moreover, while a brief continuation of existing law may be of benefit to some taxpayers, we think that it is generally agreed that the existing rules are not subject to such significant abuse that an immediate change is necessary. Postponement of new section 382 would also moot certain

technical questions regarding the application of the Bill's effective date, which are discussed below.

With respect to the law applicable during 1986, we think that 1985 section 382 should continue to apply during 1986. We also think that, on an optional basis, 1976 section 382 might also apply during 1986; while we think that this statutory provision is poorly conceived and it would be a serious error, with great detriment to taxpayers, if it were the only version of section 382 in effect during 1986, nonetheless, once having been effective, it may be inappropriate to retroactively strip its benefits from taxpayers who have taken advantage of its application. This elective application of 1976 section 382 was allowed once before, in 1978, when the old section 382 (1985 section 382) was not reinstated as the law until after January 1, 1978.

In order to apply the H.R. 3838 effective date rule, it is necessary to examine the definitions of "more than 50-percent owner shift", "trigger day" and "testing period".

A more than 50-percent owner shift would occur where (among other circumstances) a shareholder increases its percentage ownership of the stock of a loss corporation through acquisitions of stock during the testing period (new section 382(g)(2)). The term "testing period" as it relates to a more than 50-percent owner shift is defined in new section 382(k) as the 3-year period ending on the day of any "owner shift" (which

in turn is defined in new section 382(g)(4) as any change in the respective holdings in the stock of a corporation). The definition of "testing period" is modified where there has been a recent more than 50-percent owner shift. In particular, new section 382(k)(2) states that "if there has been a trigger under this section [which would include a more than 50-percent owner shift] affecting any carryforward of a loss or of an excess credit, the testing period for determining whether a 2d trigger has occurred with respect to such carryforward shall not begin before the trigger day of such earlier trigger." The term "trigger day" is defined in new section 382(1)1) to be, in the case of a more than 50-percent owner shift, the first day as of which there is such a shift.

In order to test the application of this maze of definitions, suppose that 99% of the outstanding stock of a loss corporation ("L") was purchased in a single transaction by another corporation ("P") on December 1, 1985. That purchase would constitute a more than 50-percent owner shift for which the related trigger day would be December 1, 1985. Accordingly, the new version of section 382 would not apply to the transaction because the trigger day would occur before January 1, 1986.

Suppose, however, that on or after January 1, 1986 but before October 28, 1988, one of the following events occurs: P sells 2% of the L stock to a new investor, L issues stock to a

management group as part of an incentive compensation plan, P organizes a transitory subsidiary to merge with L for the purpose of acquiring the remaining shares of L stock that it does not own, or, apparently, because stock ownership of L is tested applying section 318, there is a change in the ownership of P stock. If any of these events occurs, then that event would constitute a second more than 50-percent owner shift for which the trigger day would be the day on which the event occurs. Since the trigger day is after 1985, any net operating losses of L relating both to the period prior to December 1, 1985 and for the period from December 1, 1985 to the new trigger day would be subject to the limitations of new section 382.

This result does not make sense. If a more than 50-percent owner shift occurs between October 28 and December 31, 1985, then the testing period for purposes of determing whether there is a subsequent more than 50-percent owner shift after 1985 should commence on the day after the trigger day that occurred in 1985. The rule would parallel the general rule set forth in section 382(k)(2) to the effect that, where a trigger has occurred which affects any carryforward of a loss, the testing period for determining whether a second trigger has occurred with respect to such carryforward shall not begin before the trigger day of such earlier trigger. The reason why this provision does not solve the problem with the proposed effective date rule is that, because of the effective date

provision, a trigger attributable to a more than 50-percent owner shift for which the trigger day is prior to 1986 would not in fact affect any carryforward of a loss.

Section 321(e)(3) of H.R. 3838 provides a special transitional rule for bankruptcy proceedings. The section reads as follows:

> "In the case of a reorganization described in subparagraph (G) of section 368(a)(1) of such Code or an exchange of debt for stock in a title 11 or similar case, as defined in section 368(a)(3) of such Code, the amendments made by subsections (a), (b) and (c) shall not apply to any 50-percent equity structure change or 50-percent owner shift resulting from such a reorganization or proceeding if --
>
> (A) a plan of reorganization was filed with the court before September 26, 1985, or
>
> (B) the reorganization occurs before January 1, 1989.
>
> In any case to which subparagraph (B) applies, only the amount of claims held by persons which were creditors as of September 25, 1985, or which become creditors under written contracts which are binding on September 25, 1985, and who receive stock in the reorganization shall be taken into account."

It is not clear what it means to "take into account" only the limited group of creditors referred to above. Presumably it is not intended that the new version of section 382 would apply to a portion of the losses of a corporation and that the old version would apply to the balance. One possible interpretation is that new section 382 will generally apply, but

for purposes of determining whether there has been more than a 50-percent owner shift or a more than 50-percent equity structure change, the exchange of stock for debt claims held on September 25, 1985 would be disregarded (or the creditors would be treated as holding such stock for the period they held the debt). Under that interpretation, a question would also be posed as to whether the exchange of those claims for stock could still result in the disallowance of losses under old 382. For example, if creditors of a loss corporation received 100% of the stock of that corporation in exchange for their claims (all of which were held on September 25, 1985), and those claims were not "securities" within the meaning of section 354, then that exchange could subject the corporation to a disallowance of losses under section 382(a) if there is a change in the trade or business of the corporation. In any event, the language is not clear.

Section 321(d) of H.R. 3838 repeals subsections (e) and (f) of section 806 of the Tax Reform Act of 1976. The ostensible purpose of this change is merely to repeal the earlier version of "new section 382" that is replaced by the version set forth in the Bill. However, it has one other apparent consequence which is to eliminate section 108(e)(10)(C), which allows a corporation to exchange stock for debt without recognizing discharge of indebtedness income in certain nonbankruptcy workouts. The workout exception was added

by section 59(b) of the Tax Reform Act of 1984. Section 59(b)(2) states that the amendment "shall take effect as if it had been included in the amendments made by subsections (e) and (f) of section 806 of the Tax Reform Act of 1976". The reason for the delayed effective date for the workout exception was to insure that effective limitations on the survival of losses following a change in ownership would be in place when the workout exception came into play. Presumably, the Bill's version of section 382 provides such limitations.

D. Tax Shelters

The Bill would make two principal changes in the area of tax shelters: First, it would extend the at-risk rules to the holding of real estate, except with respect to specific types of nonrecourse financing; second, it would extend the limitations on deductibility of "investment" interest. The at-risk provision would apply to property acquired after 1985, and the interest limitation would apply to interest paid or incurred in taxable years beginning on or after January 1, 1986 (regardless of when the taxpayer incurred the debt obligation) and would phase in over a ten-year period.

The tax shelter provisons seek to remedy defects in the current law rather than to prevent abuses. Thus, it seems appropriate to defer the effective date of those provisions until the taxable year beginning after the year of the Bill's enactment. In particular, it seems unfair to apply the new

investment interest restrictions to indebtedness the taxpayer incurred in past years, even with a ten-year phase-in period. Accordingly, we recommend that the restrictions apply only to indebtedness taxpayers incur in years after 1986.

## E. Alternative Minimum Tax

Section 501 of the Bill would substantially revise the alternative minimum tax provisions. The base subject to the tax would be expanded and the tax rate would be increased from 20 to 25 percent. The Bill would also make "excess passive activity losses" -- i.e., the excess of losses from passive activities over the aggregate income from such activities -- nondeductible in calculating the base. The new provisions would generally take effect in taxable years beginning after 1985.

As the Bill now reads, the new alternative tax system would begin to apply to taxable years beginning after December 31, 1985. In the case of corporations, that is the same time as the elimination of special treatment for corporate capital gains (which, as noted above, is six months before the reduced regular rates for corporations take effect). We believe that that result imposes an undue burden on corporations, and that the increase in the tax rate to 25% should become effective on the same date as all other provisions affecting tax rates.

We also recommend that changes affecting the base subject to the alternative minimum tax should apply only to transactions entered into after the effective date, particularly

with respect to the provisions involving excess passive activity losses. The alternate minimum tax "passive activity" loss disallowance rules drastically affect many taxpayers who have previously dedicated considerable percentages of their assets to such activities in reliance on present law. Furthermore, interests in such activities are usually not readily transferable, limiting the taxpayer's ability to ameliorate his situation by transfer to a person without alternative minimum tax concerns.

The Bill also makes interest on "nonessential function" tax-exempt bonds an item of tax preference. New section 57(a)(6) makes this change effective for bonds issued after December 31, 1985, with an exception for bonds issued to refund bonds issued before January 1, 1986. Unlike the transitional rule for refunding bonds in the effective date provision for the tax-exempt bond changes, see section 703(d) of the Bill, section 57(a)(6) does not refer to a "series of refundings." Presumably the same policies should apply under both provisions, and we recommend that the section 57(a)(6) exception for refunding bonds be conformed to the section 703(d) transitional rule.

F. Foreign Taxes

Title VI of the Bill would revise many provisions involving taxes on foreign-earned income. It would amend the calculation of the foreign tax credit, the rules for determining the source of income, the taxation of income of foreign

corporations, and the taxation of foreign exchange gain or loss and would enact other miscellaneous provisions (including imposing a "second-level branch tax" on foreign corporations doing business in the United States through a branch office). The Bill would also provide that, except for certain interest payments to financial institutions, interest paid by 80-20 companies is United States-source income. Nonetheless, in specific cases interest from 80-20 companies would not be subject to withholding.

The foreign tax credit provisions are generally to take effect in 1986, as are the rules relating to source of income. Certain provisions involving deductions for qualified research and development expenditures are to apply to taxable years beginning between August 1, 1985 and August 1, 1987. Rules involving U.S. taxation of foreign corporations' income are, for the most part (including for purposes of the second level branch tax), also to take effect in years following 1985. The provisions regarding 80-20 companies are generally effective for dividends and interest paid after December 31, 1985, except that interest on obligations held on December 31, 1985, is not subject to the new rules.

Title VI of the Bill would effect a sweeping revision of the current foreign taxation system. Particular provisions -- for example, the method of calculating the foreign tax credit -- would significantly affect the operations of a large number

of taxpayers, which developed in reliance on now applicable principles. We note that in the past the United States has wavered on the question of whether taxpayers must calculate the available credit on a per-country or an overall basis, an area in which the Bill alters current law. We note further that problems in at least three areas would result from imposing the new rules currently: first, section 611's changes in the rules regarding source of income would impose a burden on foreign taxpayers who generally are relatively unfamiliar with United States law and who must determine whether particular transactions result in United States-source income; second, the source rules (as well as the changes in branch taxes) affect (and therefore leave uncertain) the amount of withholding taxes payable; finally, the changes that section 612 of the Bill would make in the treatment of 80-20 companies leave the status of income from such entities (and withholding in respect of dividends and interest paid by such entities) uncertain until the Bill's enactment.

The reasons cited for the changes indicate that the changes are motivated at least in part by a concern that long-appreciated conflicting considerations will be seriously unbalanced by the reductions in tax rates contained elsewhere in the proposed legislation (e.g. the foreign tax credit/source rule provisions generally) or a desire to resolve ambiguities or uncertainties in proper tax policy (e.g. taxation of foreign

exchange gain or loss or allocation of research and development costs). They generally do not involve putting an end to perceived abuses or to practices that were overlooked in the legislative consideration leading to the presently existing law.

Accordingly, we think it appropriate to make the foreign tax credit changes effective for tax years beginning on or after the same date as the basic tax rate changes and to defer the general effective date for the rest of Title VI of the Bill until 1987. Because the restrictions imposed by Section 602 of the Bill could precipitate a wave of loans if postponed, we believe that it may be appropriate to preserve the presently proposed transition rule for loans made to certain developing countries. We believe, however, that it would be appropriate to extend the transition period to take into account the actual enactment date of the Bill, and that in view of the relatively short transition time proposed consideration might properly be given to minimizing administrative difficulties by not limiting the transition rule to loans outstanding on a specific date.

G. Municipal Bonds

The Bill classifies tax-exempt bonds into two categories: essential function bonds and nonessential function bonds. Essential function bonds, which include general obligation bonds for traditional governmental purposes, are subjected to new requirements -- including a requirement that the issuer account for and pay over to the federal government

any arbitrage profit from investments in "nonpurpose obligations" and a requirement that at least 5 percent of bond proceeds be expended within 30 days of the issuance of the bonds. The purposes for which nonessential function bonds may be issued are restricted, all of the net bond proceeds (rather than 90%) must be expended for permitted purposes, and the total amount of nonessential function bonds is limited by a more stringent volume cap.

These changes are generally effective January 1, 1986. Grandfather rules are provided for a variety of specific issues or issuers. While the Bill also includes general grandfather rules for refunding bonds and transactions for which binding commitments (including commencement of construction) were made prior to September 26, 1985, bonds issued under these grandfather rules are subject to many of the Bill's changes (including the arbitrage rebate requirement).

The general considerations stated at the outset of this report support a general deferral of the effective date of these changes. We recognize, nevertheless, that postponed effective dates for tax-exempt bond changes may stimulate a rush to market, which occurred in 1985, and that retention of the January 1, 1986 effective date may be supported on that ground. However, a major problem with retaining the January 1, 1986 effective date is that it is not applied to many transactions that have already been grandfathered and similar relief may be

expected for other transactions. Under a general transitional rule such a large number of specific grandfather rules would be unnecessary.

If a January 1, 1986 effective date is retained for nonessential function bonds, in order to restrict the volume of such bonds issued in 1986, we would urge that the effective date be deferred for essential function bonds. The volume of such bonds issued since the beginning of the year has been very small, and the bonds that have been issued have paid an interest rate penalty of 25 to 40 basis points compared to similar 1985 bonds trading in the secondary markets. Some issuers, such as the State of Georgia, have announced they are unable to comply with certain of the Bill's requirements and are, therefore, barred from issuing tax-exempt bonds at the present time. For purposes of this effective date deferral, bonds should be considered essential function bonds if the issuer reasonably expects when the bonds are issued that their proceeds will be spent, and the financed facilities will be used, in a fashion that would make the bonds essential function bonds.

We are particularly concerned about small general obligation issuers who do not have sophisticated accounting procedures that are necessary to demonstrate compliance with the Bill's rules regarding the timing of expenditure of bond or note proceeds and the arbitrage rebate requirement. One New York City law firm tabulated the general obligation issues for which

it served as bond counsel in 1985; of a total of 1559 issues, 760 were issues of notes having an aggregate principal amount of $250,000 or less. At a minimum, the effective date should be postponed until January 1, 1987 for small issuers.

H. Financial Institutions

The Bill would restrict the ability of certain financial institutions to claim a deduction for bad debt reserves, effective for taxable years beginning after 1985. The Bill would also limit the extent to which such institutions could claim a deduction for interest expenses attributable to tax-exempt securities, which would generally apply to obligations the taxpayer acquired after 1985. The interest limitation would not apply, however, to an obligation acquired after 1985 pursuant to a "direct or indirect written commitment" to purchase the obligation entered into before September 25, 1985. The Bill would also repeal special reorganization provisions applicable to financial institutions, terminate the special 10-year loss carryback rules, and amend the treatment of losses on deposits in insolvent financial institutions (generally so as to make that provision more favorable to taxpayers). The latter provision would be effective for taxable years beginning after 1982; the other provisions would take effect in taxable years beginning after 1985.

We believe that it is appropriate to maintain the effective date of the provision amending losses on deposits in

insolvent financial institutions as it now stands, allowing taxpayers to file amended returns for open years. The other provisions affecting financial institutions represent significant changes in laws that have existed for a significant period and have been subject to frequent congressional review and amendement. In particular, the exemption of banks from the provisions of section 265 of the Code has been a focus of periodic inquiry. We note that in 1985 banks bought significant amounts of obligations that, under the Bill's grandfather provisions, would not be subject to the Bill's provisions. Nonetheless, we believe that the new section 265 rules should only apply to obligations purchased in taxable years beginning after enactment of the Bill.

## I. Accounting Changes

The Bill would significantly change the tax accounting provisions of the Code. It would limit the cash method of accounting, treat a pledge of an installment obligation as a disposition of the obligation, repeal the completed contract method of accounting, and repeal the bad-debt reserve for taxpayers other than financial institutions. The Bill would also make certain changes affecting only the timber and agriculture industries.

Generally, the accounting method changes would apply to taxable years beginning after 1985. The installment pledge provisions would apply to any indebtedness that becomes "secured

indebtedness," or with respect to which security is renewed, after 1985, as well as to instruments that become "secured indebtedness" before January 1, 1986 in respect of transactions occurring after September 25, 1985. The completed contract provisions would apply to any contract entered into after September 24, 1985.

We believe that Congress should postpone the effective dates of all accounting provisions for one year. Currently, taxpayers must maintain books and records as if currently effective law were applicable. Requiring taxpayers to revise their accounting later in the year would impose a significant administrative burden on taxpayers. Because accounting changes largely have a one-time only tax and revenue effect, postponing the effective date simply defers the period in which the revenue gain is realized and does not cause a permanent loss of revenue. Accordingly, we recommend that the accounting provisions generally not take effect until 1987. We recognize, however, that extending the effective date for pledges of installment obligations might lead to a wave of pledges; thus, it may be appropriate to retain the currently proposed effective date for that provision.

## J. Insurance Products and Companies

The Bill would make several changes in the treatment of insurance companies and insurance products. Among the new provisions are the repeal of the exclusion from income of

interest on installment payments of life insurance products, the repeal of the "special" life insurance company deduction, and the denial of tax-exempt status to corporations that provide a substantial amount of commercial-type insurance. In addition, the bill would revise the taxation of property and casualty insurers.

The provisions affecting insurance companies are generally to apply to taxable years beginning after 1985.

In keeping with our general view that the Bill's provisions should not, absent a pressing policy concern, become effective in the current taxable year, we recommend that the provisions relating to insurance companies take effect in taxable years beginning on or after January 1, 1987.

K. Pensions, Deferred Compensation, and Fringe Benefits

The Bill would change the treatment of qualified retirement plans and fringe benefits. For example, it would restrict the deductible contributions to IRAs and section 401(k) plans, revise nondiscrimination requirements and the treatment of distributions from certain plans, and would make additional fringe benefits taxable.

Generally, these provisions are to apply to taxable years beginning after 1985. In some cases, special rules deferring the effective date until the earlier of 1991 or the date the agreement terminates apply to certain plans maintained pursuant to a collective bargaining agreement. Section 1137 of

the Bill also provides that, if the Bill requires amendments in existing plans, employers have until January 1, 1988 to make such amendments. The provisions affecting certain statutory fringe benefit plans would take effect in taxable years beginning after December 31, 1986.

In the past we have recommended effective dates that give taxpayers a reasonable time in which to comply with significant substantive changes in the law in the area of tax-qualified plans and for the adoption of plan amendments. As was true in the case of ERISA adopted in 1974, compliance with changes in requirements for plan qualification under H.R. 3838 should not be mandatory until a reasonable lead time (at least one full calendar year) has elapsed after enactment. Further lead time should be allowed for compliance and plan amendments since regulations are needed in order to specify the details of the required changes.[11] Although H.R. 3838 provides that plan amendments are not required before the first plan year beginning on or after January 1, 1988, this delay is of little help

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[11] Plans should not be required to be amended to comply with unclear statutes, further amended to comply with temporary regulations and then amended once more when regulations are finally issued. This is the situation facing practitioners and employers after the enactment of the Retirement Equity Act of 1984, effective August 23, 1984, and the issuance of temporary regulations, effective July 19, 1985 and earlier and Announcement 85-152, 1985-43 I.R.B. 29 (based on News Release IR 85-99, dated October 2, 1985) altering the regulations. See also Notice 86-3, 1986-9 I.R.B. ___.

because the effective dates for compliance under the Bill for the most part apply to taxable years or plan years beginning after December 31, 1985. Thus, under the Bill as passed by the House, compliance will be necessary immediately (or retroactively) upon enactment even though the formality of plan amendments may be delayed.

Immediate or retroactive effective dates are undesirable and impractical. For example, a dollar-for-dollar reduction in the IRA limit to the extent of salary reductions under section 401(k) plans or section 403(b) annuities, or imposition of a maximum amount of salary reductions in section 401(k) plans cannot be retroactively implemented in cases in which many taxpayers have made their IRA or 401(k) contributions for 1986 before passage of any tax act. Individual tax planning with respect to lump sum distributions as well as planning by employers with respect to meeting discrimination tests under section 401(k) and with respect to matching contributions should not be upset in the middle of 1986.

We again recommend that any legislation affecting tax-qualified plans should have prospective effective dates for purposes of both compliance and plan amendments. Ideally, such effective dates should commence no earlier than six months after all regulations pertaining to a new act's provisions are issued. Under no circumstances should any of the effective dates for compliance with provisions affecting the tax qualification of

plans be retroactive or even immediate. Effective dates should not be earlier than plan or taxable years beginning after December 31, 1987. Finally, any amendment period should not expire earlier than the later of (i) the last day of the plan year for which the amendment is first required to be effective or (ii) the time (with extensions) for filing the tax return for the taxable year of the employer for the year in which ends the plan year for which the plan amendment is first required to be effective, if an application for a determination letter with respect to the amendment is filed by such date. The legislative history should also encourage the Treasury Department to further postpone the deadline for plan amendments until after regulations have been issued to provide sufficient guidance for such amendments.[12]

L. Unearned Income, Trusts, and Estates

The Bill would insert new provisions regarding the unearned income of certain minor children, which would take effect in taxable years beginning after December 31, 1985. It would also revise the income tax treatment of trusts and estates, which amendments would be effective as of September 25, 1985 for existing revocable trusts, for trusts created or additions to irrevocable trusts after that date and for estates of decedents dying on or after that date. The Bill would also

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[12] This treatment would be similar to that provided for remedial amendments under ERISA.

impose a new tax on generation skipping transfers, repealing the current tax on such transfers. Generally, the new tax would become effective upon the date of the Bill's enactment, except that inter vivos transfers (not including certain transfers under a trust) after September 25, 1985 and before the date of enactment would also be subject to the new provision.

The change in taxation of unearned income of certain minor children, which requires such income to be taxable at the marginal tax rate applicable to the child's parent, should be regarded as a change in rate. Making the change applicable to the 1986 calendar year may, however, create certain administrative problems. Presumably provision should be made for excusing failure to pay estimated taxes at the proper rate. Also, the Bill contemplates a child's assets derived from nonparental sources may be set aside in a segregated account and taxed at the child's tax rates, and it may be difficult to implement the segregated asset account rule by the due date for the child's 1986 return if the Bill is not enacted until the end of the year.

The changes in the income tax treatment of trusts and estates could also be regarded as rate changes. They essentially involve expanding the situations in which trust income will be taxed at the grantor's marginal rate during the life of the grantor and taking away the ability to split up estate income among several beneficiaries by denying a

distributions deduction to the estate. From that point of view an argument could be made that grandfather rule treatment, such as excluding all irrevocable trusts created before September 25, 1985, is not necessary and that an acceptable alternative would be to phase-in the effects of the changes over a period of years. On balance, however, we believe that grandfather treatment is preferable. Until the legislation is enacted, either approach creates uncertainty and makes it difficult for estate planners to draft trusts and for estate administrators to determine the amount of estate distributions. For example, persons drafting trusts must consider the potential applicability of the new concepts of "qualified beneficiary trusts" and "qualified children's trusts." And the amount that an estate may prudently distribute is obviously greatly affected by uncertainty whether the estate may deduct the amount of the distribution in determining its taxable income.

Accordingly, we recommend that the above provisions take effect only for taxable years beginning after enactment of the Bill except that the changes in trust taxation could apply to transfers to trusts after the date of enactment.

### M. Compliance and Tax Administration

Among other compliance-related matters, Title XIII of the Bill would amend or create several civil penalties. It would increase the penalties for failure to file information returns and for failure to pay taxes due, as well as modifying

penalties applicable in the case of fraud or negligence. The Bill would revise the "safe harbor" provisions for estimated tax payments.

The provisions relating to failure to file information returns, as well as the provisions regarding negligence and fraud, would affect returns due after December 31, 1985. The penalties for failure to pay tax due would cover taxes assessed after December 31, 1985. The estimated tax provisions would apply to all taxable years beginning after December 31, 1985.

In their current form, the penalty provisions would in many cases apply to returns or payments of tax that come due before the Bill is enacted. In view of the unfairness and, with respect to new penalty provisions, the constitutional concerns inherent in such retroactivity, we recommend that the penalty provisions apply only to returns due and taxes assessed in taxable years beginning after the date on which the Bill is enacted, or at least only to returns due and taxes assessed after the enactment date.