# TAX SECTION

# New York State Bar Association



April 1, 1986

The Honorable Dan Rostenkowski
2232 Rayburn Building
Washington, DC 20515

Dear Representative Rostenkowski:

Enclosed is a report prepared by the Tax Section of the New York State Bar Association discussing the alternative minimum tax provisions of H.R. 3838. The report was prepared and approved by the Tax Section before the Senate Finance Committee's mark-up proposals were announced. Therefore, it does not take into account the Senate Finance Committee proposals.

However, I wish to draw your attention to the following points raised by those proposals.

1) The Senate Finance Committee's proposal for an alternative minimum tax rate of 20% (rather than 25% as in H.R. 3838) is a step in the direction recommended by the report. This step would still be insufficient, however, to maintain the ratio of the alternative minimum tax rate to the highest regular tax rate at approximately its level under current law, that is 4:10. Accordingly, the Senate Finance Committee proposal would still have the effect of subjecting many more taxpayers to the alternative minimum tax than does existing law.

2) The recent clamor in the tax-exempt bond markets over the possibility of subjecting all § 103 interest to the alternative minimum tax illustrates the hazards, described in the report, of attempting to achieve major policy shifts sub silentio through the alternative minimum tax.

I hope that the report's comments on H.R. 3838 will be relevant to consideration and mark-up of the alternative minimum tax proposals. The Tax Section expects to submit a supplemental report on the alternative minimum tax later this year if and to the extent warranted by future legislative developments.

Sincerely,

Richard G. Cohen

Enclosure
cc: The Hon. John J. Duncan )with
Robert J. Leonard, Esq. )enclosure

# TAX SECTION

# New York State Bar Association



April 1, 1986

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

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Richard G. Cohen

Enclosure
cc: The Hon. Russell B. Long )with
John Colvin, Esq. )enclosure

# TAX SECTION

# New York State Bar Association



April 1, 1986

The Honorable David H. Brockway
Chief of Staff
1015 Longworth Building
Washington, DC 20515

Dear Dave:

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Richard G. Cohen

Enclosure

# TAX SECTION

# New York State Bar Association



April 1, 1986

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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Richard G. Cohen

Enclosure

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

Alternative Minimum Tax Committee*

# REPORT ON THE INDIVIDUAL ALTERNATIVE MINIMUM TAX PROVISIONS OF H.R. 3838, "THE TAX REFORM ACT OF 1985"

March 31, 1986

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* This report was written by Eugene L. Vogel, William H. Weigel, Kathleen L. Ferrell and Willard S. Moore. Helpful comments were received from Dale S. Collinson and Richard G. Cohen.

## INTRODUCTION

H.R. 3838, "The Tax Reform Act of 1985," as passed by the House on December 17, 1985 (the "Bill"), would augment in several respects the individual alternative minimum tax ("AMT") provisions of current law and would replace the present corporate add-on minimum tax with an alternative minimum tax scheme structurally integrated with the AMT proposal for individuals. The Bill would generally expand the AMT base by adding new preferences and modifying certain current law preferences and would increase the AMT rate to 25%, compared to a 20% rate under current law. The major stated purpose of the proposed expanded AMT is "to ensure that no taxpayer with substantial economic income can avoid significant tax liability by using exclusions, deductions, and credits."*

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* H.R. Rep. No. 426, 99th Cong., 1st Sess. 306 (hereafter referred to as "Committee Report").

## REPORT
## SUMMARY

Part I of this report describes the AMT provisions applicable to individuals* under the Bill. Part II summarizes the views of the Tax Section of the New York State Bar Association (the "Tax Section") as to those provisions and is generally critical for three principal reasons:

first, because the proposed rules would vastly complicate existing tax law by creating a pervasive two-tax system and the need for rules to reconcile the two;

second, because the rate differential between the AMT and the regular tax would be diminished to the point that many more taxpayers than under existing law would either pay AMT or would be near enough to paying AMT to have to take account of the AMT system in planning transactions; and

third, because the proposed AMT would make very significant policy changes to existing law sub silentio, apparently upon the misleading justification that these changes are "only" for AMT tax purposes.

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* The scope of this report is confined to the individual AMT. Nonetheless, some of its observations and criticisms apply equally to the proposed corporate AMT.

Part III of the report contains a more detailed discussion of various aspects of the proposed AMT, some of which serve as specific illustrations of the general criticisms set forth in Part II. Other matters included in Part III are observations or criticisms of a more technical nature and drafting suggestions. Part IV discusses effective dates and transitional rules and recommends a general rule of prospective application, consistent with the views of the Tax Section which have previously been publicized.*

Part V concludes the report and reiterates the Tax Section's recommendations. In brief, these recommendations are first, that the proposed AMT be greatly simplified; second, if simplification is not possible, that at least the various specific items discussed in Part III be amended in order to minimize their possible unfairness or arbitrary application; and finally, in any event that the rate differential between the regular tax and the AMT be maintained at a level comparable to that under existing law so that the AMT will only impact the relatively few high-income and highly sheltered taxpayers for whom it was originally intended.

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* New York State Bar Association Tax Section, Special Committee on Effective Dates of H.R. 3838, "Effective Dates of Tax Reform Legislation," (February 19, 1986), pp. 33-34.

## I. DESCRIPTION OF INDIVIDUAL AMT PROPOSAL

### General Structure of the Individual Alternative Minimum Tax

The Bill uses several methods to expand the tax base for AMT purposes. Proposed § 56 of the Internal Revenue Code of 1985* requires that taxable income be recomputed under alternative procedures for the most part less generous than those allowed for regular income tax purposes. Proposed § 57 defines certain "items of tax preference," which the taxpayer must add to his regularly computed taxable income. Proposed § 58 denies certain deductions allowable for regular income tax purposes. The excess of the taxpayer's income, so recomputed, over an exemption amount,** is then multiplied by 25% and reduced by the AMT foreign tax credit to produce the tentative minimum tax. The excess of the taxpayer's tentative minimum tax over his regular income tax liability is the taxpayer's AMT liability.

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* Proposed sections of the Internal Revenue Code of 1985 as included in the Bill are referred to hereafter as "proposed § ____." Unless otherwise specified, other references to sections or to the "Code" are to the Internal Revenue Code of 1954, as amended.

** The exemption amounts are $40,000 for married couples filing jointly, $30,000 for single individuals, and $40,000 for corporations.

Recovery of Capital Costs

Proposed § 56(a)(1) provides that, in computing AMT income, depreciation deductions for property placed in service after 1985 shall be computed under the nonincentive depreciation system of proposed § 168(h). Proposed § 168(h) provides generally for depreciation deductions to be taken on a straight-line basis over the ADR class life of the asset being depreciated. Proposed § 56(a)(1) differs from current law (1) by requiring that depreciation deductions on all assets be recomputed, thus permitting taxpayers effectively to offset depreciation deductions in excess of the straight-line amount with deductions from other assets (in the later years of their useful lives) below the straight-line amount, and (2) by requiring recomputation of depreciation deductions for all tangible property, rather than, as under current law, for real property and leased personal property only.

For property placed in service before 1986, proposed § 57(a)(9) generally provides that the provisions of current law, under which accelerated depreciation on real property and leased personal property gives rise to an item of tax preference on an asset-by-asset basis, continue to apply.

The Bill would retain the current rules restricting, for AMT purposes, certain preferences relating to natural resources which are permitted under the regular income tax.

Proposed § 56(a)(2) provides that, in computing AMT income, certain deductible mining development and exploration costs must be capitalized and amortized ratably over a ten-year period. Proposed § 57(a)(3) provides that the percentage depletion deduction allowed by §§ 611 and 613 of the Code is an item of tax preference to the extent that it exceeds the basis of the property for which the depletion deduction is allowed. In effect, for AMT purposes, a taxpayer may take percentage depletion deductions only until the total amount of such deductions equals the cost of the property. In addition, proposed § 57(a)(4) makes "excess intangible drilling costs" an item of tax preference. The amount of the preference is equal to the deduction permitted for intangible drilling costs under the regular income tax, reduced first by the amount that would have been permitted if such costs were amortized over five years, and further reduced by 65 percent of the taxpayer's net income from oil, gas, and geothermal properties.

In addition, proposed § 56(b)(2) provides that, as under the current AMT, individuals are not permitted the deductions allowed by §§ 173 and 174 of the Code for circulation expenditures and research and experimentation expenditures, respectively. In computing AMT income, individuals would be required to amortize expenditures described in § 173 of the Code over three years, and those described in § 174

over ten years.

Dispositions of Capital Assets

For regular tax purposes the Bill provides for a 42% net capital gains deduction under proposed § 1202 and a top individual marginal tax rate of 38%, producing a top effective tax rate of 22% on long-term capital gains.* Proposed § 57(a)(1) ensures that the rate on long-term capital gains under the AMT will also be 22% by providing, in effect, that 30% of the taxpayer's net long-term capital gains constitutes an item of tax preference.** The 25% AMT rate would thus be applied to 88% of the taxpayer's long-term capital gains (58% included as regular taxable income plus 30% as AMT income) resulting in a 22% effective tax rate.

With respect to charitable contributions of appreciated property, proposed §§ 57(a)(2) and 57(b) treat the amount of unrealized appreciation included in the deduction allowed under § 170 as a preference. However, proposed § 57(b)(1)(B) provides that the preference amount shall not

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* Inasmuch as the regular income tax provisions of the Bill would abolish the lower tax rate imposed under current law on corporate capital gains, the capital gains preference in general survives only for individuals.

** Proposed § 57(a)(1) technically includes as a preference item an amount equal to the excess of the regular tax capital gain deduction (42% of the net capital gain) over "3/25 [i.e., 12%] of the amount of the net capital gain."

exceed the amount by which a taxpayer's AMT income (computed without regard to this item) exceeds his regular taxable income. The Committee Report further states that in comparing AMT income and regular taxable income for these purposes, AMT income is computed by allowing all of the itemized deductions allowed in computing regular taxable income.* Therefore, a taxpayer whose adjusted gross income is not affected by the computations required for AMT purposes will not incur AMT liability solely as a result of charitable contributions of appreciated property. The appreciated property charitable deduction is the only item of tax preference for which this limitation is provided.

The Bill retains, in proposed § 57(a)(5), the current law treatment of incentive stock options ("ISO's") for AMT purposes, providing that the exercise of an ISO results in an item of tax preference in an amount equal to the excess of the fair market value of the stock over the option price. In effect, the gain resulting from exercise of the option, which may be deferred for regular income tax purposes until the stock is sold (and then recognized at capital gains rates), would have to be included immediately in AMT income.

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* Id. at 314 n.9.

Accounting Methods

Proposed § 56(a)(3), in a change from current law, provides that in computing AMT income, a taxpayer must use the percentage of completion method of accounting (rather than the completed contract method) to compute the income derived from any long-term contract. The effect of this rule may be minimal, however, because proposed § 459 would allow the use of the completed contract method in computing income for regular income tax purposes only by small construction companies and only for contracts that will be completed within two years.

Foreign Income Provisions

The Bill also includes in AMT income certain items of foreign income that are excluded from regular taxable income. Proposed § 57(a)(7) provides that the amount of foreign earned income excluded from gross income under § 911(a)(1) of the Code constitutes an item of tax preference. Section 911, as it would be modified under § 644 of the Bill, would provide that United States individuals who reside and render services abroad (and who are therefore generally subject to foreign income taxation) may exclude up to $75,000 in foreign earned income from their taxable income.

Proposed § 56(a)(6) provides that shareholders of a foreign sales corporation ("FSC") shall include in AMT

income their proportionate shares of the gross income, deductions, and taxes of the FSC. Thus, although a portion of the income of a FSC may generally be earned and repatriated without any regular income tax, such income may produce AMT liability. Similarly, the entire taxable income of a domestic international sales corporation ("DISC") is deemed to be distributed to the shareholders of the DISC in computing their AMT income.

Tax-Exempt Interest

Proposed § 57(a)(6) provides that the interest received on otherwise tax-exempt state and municipal bonds that are classified as "nonessential function" bonds under the Bill* constitutes an item of tax preference. "Nonessential function bonds," as defined in proposed § 141, generally are bonds more than a specified percentage of the proceeds of which are used either to make loans to persons other than governmental units, or in a trade or business carried on by a person other than a governmental unit. The AMT preference would arise from interest on special categories of "nonessential function" bonds for which the § 103 tax exemption is

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* Sections 701-703 of the Bill.

continued, including "exempt facility" bonds,* certain mortgage subsidy, student loan, and redevelopment bonds, and bonds issued for the benefit of § 501(c) organizations if the proceeds are used in activities directly related to the organization's charitable purpose.

Net Operating Losses

Proposed § 56(c) and the effective date rules of the Bill retain and extend into the future the general principles of current law concerning the effect of net operating losses ("NOL's") on AMT income. In general, the amount of the AMT NOL deduction is recomputed following the general AMT rules, whether the losses giving rise to the NOL occurred in an AMT year or are being carried forward from a regular tax year. AMT NOL's may be carried forward or back, just as regular NOL's may be.

Itemized Deductions

Only a limited number of the itemized deductions allowed for regular income tax purposes are allowed in comput-

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* Facilities eligible for tax-exempt financing under the "exempt facility" exception include airports, docks and wharves, mass commuting facilities, facilities for the furnishing of water (other than for irrigation), sewage disposal facilities, solid waste disposal facilities, and qualified multifamily residential rental projects. Committee Report at 527.

ing AMT income. In general, the provisions of the Bill in this area are the same as the provisions of current law. Proposed § 56(d)(1) provides that, as under current law, deductions allowed under § 165(c)(3) of the Code for casualty losses, and under § 165(d) of the Code for wagering losses, are allowed in computing AMT income. Also, again as under current law, the deduction allowed for charitable contributions under § 170 of the Code is allowed for AMT purposes, subject to the rules for gifts of appreciated property described above.

Under proposed § 56(d)(7) the deduction for medical expenses allowed for regular income tax purposes under § 213 would also be allowed in computing AMT income but only to the extent that such expenses exceed 10% of the taxpayer's adjusted gross income, compared to a 5% threshold under the regular tax. The regular income tax deduction allowed under § 691(c) of the Code for estate taxes is also allowed in computing AMT income. In addition, proposed § 56(d)(6) provides that estates and trusts are entitled to deductions for certain amounts contributed to charity or distributed to beneficiaries. These provisions also appear in current law.

Proposed § 56(d) follows current law in permitting only a limited deduction for interest expense. The impact of this provision would be reduced, however, because the Bill

would also amend § 163(d) to restrict further the interest deduction allowed for regular income tax purposes.

The foregoing are the only itemized deductions allowed in computing AMT income. In particular, no deduction is allowed for such items as state and local taxes, expenses for investment advice, employee business expenses, amortization of bond premiums, or any other itemized deduction not specifically allowed under proposed § 56(d). Thus, these deductions may be termed de facto tax preferences.

Tax Shelter Losses

Perhaps the most significant proposed change in the AMT is contained in proposed § 58, which denies certain deductions otherwise allowable in computing AMT income if the deductions are attributable to passive investments. Under proposed § 58(a) no deduction would be allowed for any loss from any "tax shelter farm activity" if the loss exceeds twice the taxpayer's cash basis in the activity. The category "tax shelter farm activity" generally includes any activity involving the trade or business of farming, unless the taxpayer materially participates in the operation of the activity.

Proposed § 58(b) denies a deduction for any "excess passive activity loss." Whereas the amount of the farm loss disallowed under proposed § 58(a) is determined at the level of each farming activity, the amount of a taxpayer's "excess

passive activity loss" is determined by considering all of his activities in the aggregate. The amount disallowed under this provision would be the excess of net losses from all passive activities over the taxpayer's cash basis in activities that are not tax shelters, and the lesser of $50,000 or the taxpayer's cash basis in activities that are tax shelters. Losses disallowed by reason of proposed § 58 may be carried forward and deducted from AMT income when the taxpayer disposes of his entire interest in the activity.

For these purposes, a tax shelter is any enterprise (other than a C corporation) in which interests have been offered in a registered offering, or of which more than 35% of the losses are allocated to limited partners or other persons who do not actively participate in the management of the enterprise. The term "tax shelter" also includes any entity or arrangement having as its principal purpose the avoidance or evasion of income tax. A "passive activity" is defined generally as any trade or business in which the taxpayer does not materially participate.

Proposed § 58(c) provides that in the case of a limited partnership, a partner's cash basis is equal to the adjusted basis of his partnership interest, determined, however, without regard to any liability of the partnership, and without regard to any amount borrowed by the taxpayer,

with or without personal recourse, if the partnership or certain related persons participated in arranging the borrowing or if the borrowing is secured by any assets of the partnership. In the case of interests other than limited partnership interests, the proposed statute provides that the same principles apply in determining cash basis. Generally, it appears that only cash contributions to an activity, or amounts borrowed by the taxpayer from persons outside the activity, and not secured by the assets employed in the activity, will create cash basis.

Credits Against AMT

The AMT foreign tax credit is the only credit which may be applied in computing the AMT tentative minimum tax. Under proposed § 59(a), the AMT foreign tax credit is computed in the same fashion as is the regular foreign tax credit, except that AMT income is substituted for regular taxable income in the computation. The latter provision is generally similar to the rules provided under current law. Credits not used because of this limitation may, however, be carried forward to succeeding years.

Adjustments in Later Years

The Bill provides three mechanisms whereby adjustments may be made in a later taxable year to reflect the

taxpayer's treatment in earlier years. These mechanisms are intended to prevent the double taxation of any item of income, although it is unclear to what extent they achieve this result.

First, AMT paid with respect to any year after 1985 is allowed, under proposed § 53, as a credit against regular income tax liability in subsequent years, to the extent that the AMT liability in the prior year was the result of "deferral preferences". "Deferral preferences" are preferences, such as accelerated depreciation, that merely shift income from one year to another. In contrast, "exemption preferences", such as the exclusion from income, for regular income tax purposes, of interest on nonessential function state and municipal bonds, allow items of income to escape taxation permanently. For these purposes, the itemized deductions disallowed in computing AMT income, including state and local taxes, are classified as exemption preferences.

Second, the Bill provides, in proposed § 56(a)(5), that for AMT purposes the adjusted basis of depreciable property placed in service after 1985 and certain other properties shall be computed using the depreciation allowances provided for such property under the AMT. Therefore, any taxpayer potentially subject to the AMT will need to compute depreciation and adjusted basis under both the AMT rules and

the regular income tax on an ongoing basis. Upon the disposition of such property, the adjusted basis (and, hence, the gain realized) will differ under the regular income tax and the AMT. Under current law, the basis used in computing gain for AMT purposes reflects the depreciation deductions allowed in computing regular taxable income, even though a taxpayer who is subject to the AMT has not really received the benefit of those deductions.

Third, proposed § 59(g) authorizes the Secretary to prescribe regulations implementing the tax benefit rule. Specifically, this section would authorize "regulations under which differently treated items shall be properly adjusted where the tax treatment giving rise to such items will not result in the reduction of the taxpayer's regular tax for any taxable year". "Differently treated items" are defined by proposed § 59(d)(4) as either items of tax preference or any other items treated differently under the AMT and the regular income tax. The language of proposed § 59(g) mirrors that of current § 58(h) of the Code, enacted in 1976, which likewise authorized regulations reflecting the tax benefit rule. To date, however, no such regulations have been been issued, although there have been rulings under this section.

## II. GENERAL CONSIDERATIONS AND OVERALL RECOMMENDATIONS

The minimum tax concept stems from tax reform studies first undertaken by the Treasury Department during the Johnson Administration and has been incorporated into the Internal Revenue Code in some form since passage of the Tax Reform Act of 1969. At the most general level, a minimum tax has been accepted by the taxpaying public as an imperfect, but nevertheless satisfactory, balancing device to maintain long standing or beneficial tax incentives, while appearing to ensure that most taxpayers pay at least some taxes. Although directly refining or eliminating offending provisions of the Code has always seemed to be a more sensible -- and certainly a much simpler -- method of achieving balance in the tax system, the Tax Section acknowledges the practical political realities which have resulted in a minimum tax approach.

The proposed AMT raises several general concerns, however, which the Tax Section believes need attention. The first of these general concerns is the substantially greater complexity which would be created by the proposed AMT system. Second, the AMT provisions in the Bill include a number of decisions as to specific preference items which, because of their potentially arbitrary application in various circumstances, appear to have been insufficiently scrutinized from a

policy viewpoint. Finally, the overall impact of the AMT provisions in conjunction with the other portion of the Bill may be to establish sub silentio and de facto certain tax results which the Tax Section believes are more properly treated as regular tax issues. All of these concerns are exacerbated by the fact that the proposed AMT would have a much wider impact than the existing AMT provisions and would reach far beyond the relatively few high income taxpayers affected by existing law. Thus, even technical points which do not change existing law are subject to criticism because they would affect many more taxpayers.

Complexity

The Tax Section has encouraged the attempt at tax simplification over a great many years. For all practical purposes, Congress has never considered a major tax simplification measure, and little real progress has been made in developing a politically acceptable simplification measure. It may well be that an income tax law covering a complex society can never be very much simplified. However, even if the goal of simplification were to be abandoned, it would seem appropriate as a rear-guard action to do everything possible to resist a significant increase in the complexity of tax law provisions, particularly when those provisions will apply to a very large segment of the population. The Tax Section

believes that the proposed AMT, in the context of the other proposals of the Bill, would be just such a retrogressive increase in complexity.

The proposed AMT has many special tax provisions, different rules, separate records to be maintained and other differences that would subject the taxpaying public to the complex regular income tax system and then to the growing complexity of the quite different AMT system. If only a relatively few wealthy, heavily sheltered individuals had to worry about this complexity, the Tax Section would not be so concerned. However, the expansion of the list of tax preferences, including the de facto tax preference treatment of a number of perfectly legitimate itemized deductions,* combined with the proposals to reduce the top income tax rate from 50% to 38% and to increase the AMT rate from 20% to 25%, would subject an extremely large number of American taxpayers to the AMT or, at the very least, to the burden of having to understand it sufficiently to test their tax liability under

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* For example, such items as amortization of bond premiums, fees for investment advice and related expenses, fees for tax advice, union dues or many unreimbursed employee business expenses, and, most prominently, state and local taxes have never been considered as potential abuses. Yet these items would not be deductible in computing AMT income, and thus would be de facto items of tax preference.

both systems.* As described above and as more fully discussed below, it is difficult to avoid the conclusion that there will be significant complexity added to an already complex tax law by this proposed AMT.

Further, as also discussed in greater detail below, there is the growing recognition that there is a need to reconcile these two parallel tax systems. If reconciliation is ignored with respect to the augmented AMT, a great number of unfair results will develop where an AMT is paid in one year and then a related regular tax is paid on the same or similar item in a later year. Recognizing this, the Bill contains some modest attempts at reconciliation, but these are likely to be inadequate in many specific instances. However, the prospect of a more fully developed system of reconciliation, as welcome as that may be from the fairness viewpoint, raises the spectre of still further immense com-

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* The Tax Section has prepared an example showing that the regular tax and the proposed AMT would be approximately equal for a New York City family of four with salary income of $85,000, a long-term capital gain of $5,000, taxable dividends and interest income of $5,000, tax exempt interest income (from a "non-essential function" bond) of $5,000, a charitable contribution of property worth $5,000 with a basis of $1,000 and a limited partnership loss of $5,000. (The tax under either system would be approximately $14,800.) Such a family is clearly not one which has made extensive or aggressive use of tax shelters or abusive transactions; nonetheless, the AMT under the Bill would become applicable to them and thus an integral part of their financial planning.

plications, creating a tax system under which taxpayers, their advisors and IRS personnel will have to deal with the regular tax system, the AMT system and an elaborate system that reconciles the two. Thus, the introduction of an AMT with very broad applicability has the effect of "tripling," as it were, the complexity inherent in a single tax system.

There is another general problem growing out of this two-track tax system that is closely related to the complexity issue. Taxpayers have always had to deal with some level of uncertainty not only in the interpretation of the tax law but also in the unpredictability of financial events as they unfold during the year. However, this latter problem would be made very much worse by the AMT as now proposed to be augmented and made more widespread in application. The proposed AMT would have the effect of putting a large number of taxpayers in the situation of not knowing on any given day which set of tax rules will apply to their transactions. This would, of course, be true of persons having to deal with this situation without the benefit of expert advice. However, even for those taxpayers with ample legal and accounting service (and computer capability) it may become impossible to know, say, in August, whether the payment of an item of interest, the settlement of a property tax controversy or the exercise of an incentive stock option will have correlative tax conse-

quences equal to 38% of the amount in question or no consequences at all. The Tax Section believes that affected taxpayers, by no means limited to "preference abusers," deserve to know with more certainty the tax impact of their transactions when made. Furthermore, a new element of difficulty would be added to a taxpayer's attempt (where a protective estimate is not feasible) to arrive at appropriate estimated tax payments.

The specific topics set forth below include numerous examples of the complexities which would be created by this expanded AMT. Of particular relevance in this regard are the rules relating to recognition of deferred losses and those relating to excess passive activity losses.

Arbitrariness under Specific Provisions

Certain elements of the proposed AMT also appear arbitrary and potentially unfair. This arbitrariness, whether the result of drafting with inadequate opportunity for public understanding and comment, or simply a desire to raise revenue, presents disturbing policy concerns. These concerns are evident, for example, in the distinction between essential and non-essential function municipal bonds and in the treatment of foreign earned income. These and various other examples are discussed in Part III below.

Sub Silentio Legislation

Finally, one of the most serious general policy issues raised by the proposed AMT is the tendency of these provisions to perform as substitutes for direct reform of the regular tax item giving rise to the AMT preference. This concern may be best illustrated by the treatment of state and local taxes. After extensive debate on the regular tax deduction for state and local taxes the House of Representatives made a policy decision to retain that deduction, notwithstanding the Administration's recommendation to the contrary. The Tax Section has set forth its strong agreement with this decision. Yet, because state and local taxes would not be deductible for AMT purposes and because the AMT would be more widely applicable, we believe that a great many taxpayers, particularly in higher tax states, will in fact not receive tax deductions for state and local taxes.*

The state and local tax issue is only one example of the more general concern that the AMT as now proposed operates to enact major changes in tax policy approaching a flat tax system without adequate debate or understanding by the public. At the very least, this inadequate understanding of the

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* The taxpayer in the footnote example above, like any other taxpayer subject to the AMT, would be in the position of receiving no marginal federal tax benefit for a marginal dollar of state or local income tax.

proposed AMT must be corrected. Other items of this type are discussed under Part III of this report.

Tax Section Recommendations

The Tax Section believes that the substantial additional complexity and the arbitrariness that would be created by the proposed AMT deserve strong criticism in large part because of the number of taxpayers who would be affected. This very serious shortcoming could be ameliorated first and most directly by overhauling the overall structure of the AMT to produce a very simple flat tax.*

Second, if that approach is not feasible, we urge that more careful policy consideration be given to the treatment of numerous specific items as direct or de facto AMT preferences, some of which are discussed in Part III below, so as to eliminate those items which are potentially arbitrary or unfair in their application, or which tend to contravene clear Congressional objectives.

Finally, and in any event, we urge strongly that

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* An example of such an approach is that proposed in Schapiro, "Sheltering the Revenue from Shelters," 22 Tax Notes 811 (1984). The Tax Section (of which Mr. Schapiro is a member) has not specifically approved all of the details of that proposal. Nevertheless, it is a useful example of a system which would serve the AMT goal of ensuring that all taxpayers pay some tax on their significant sources of income and would be much simpler than the proposed AMT.

the ratio between the AMT rate and the maximum regular tax rate be maintained at approximately what it is under existing law, i.e., 0.4 (20%/50%). This would mean an AMT rate of about 15% and, we believe, would relegate the AMT to its proper role of preventing wealthy taxpayers and those making extensive use of tax preferences from avoiding tax entirely. The Tax Section finds this approach vastly more desirable than that proposed in the Bill, which would create a shadow tax system applicable to a much larger class of taxpayers than does the current AMT.

## III. COMMENTS AS TO SPECIFIC PROVISIONS

This portion of the report treats various specific topics under the proposed AMT, identifying items which the Tax Section believes need to be amended. These criticisms are by no means exhaustive, yet they do include those which the Tax Section perceives to be among the most significant.

### Recognition of Deferred Losses

One clear example of the complexity created by the proposed AMT provisions is the treatment in later years of disallowed losses. The Bill includes various provisions that would have the effect of allowing for AMT purposes various deductions that would have been disallowed in prior years if there were an ultimate disposition of the taxpayer's interest in the activity.

Although the Tax Section believes that this allowance is appropriate as a general matter, these provisions present several interpretative difficulties. First, they appear to have been drafted separately, and it is difficult to understand why they employ different criteria and different operative mechanisms. Second, certain of these rules appear to overlap. Finally, it is unclear as a drafting matter when certain of these rules are triggered. Set forth below are several specific questions reflecting these difficulties,

although this is not a complete list.

1. Separate rules are provided for (i) depreciation (proposed § 56(a)(5)), (ii) mining exploration and development costs, circulation and R&D expenditures (proposed § 56(a)(2)(B) and § 56(b)(2)(B)), and (iii) excess farm losses and excess passive activity losses (proposed § 58(c)(4)). Why does the Bill not utilize the same form of rule (e.g., a comprehensive AMT basis rule) for all of these? Furthermore, why are some other "timing" preferences excluded (e.g., pre-1986 accelerated depreciation and intangible drilling costs)?

2. Why, in the case of the rules described in clause (ii) above, is the allowance of the suspended amount triggered only if a loss is sustained, rather than upon any disposition of the taxpayer's interest in the activity? Furthermore, how is it determined whether the taxpayer has sustained a loss (i.e., is the loss determined with reference to regular tax basis rules or with reference to AMT basis rules)?*

3. Why are the clause (ii) rules necessary at all if proposed § 56(a)(5) provides an AMT basis adjustment for these items?

Without attempting a full explication of all of these issues,

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* Suppose, for example, that a taxpayer invests $20,000 in a partnership which creates a patent using $15,000 of the taxpayer's contribution and retains the remaining $5,000 as working capital. The taxpayer takes regular tax deductions under § 174 of the Code and reduces his basis to $5,000. If he sells his partnership interest immediately after the close of the first taxable year for $4,000, it is clear that he has sustained a loss, thus triggering proposed § 56(b)(2)(B). If he sells for $6,000, however, he has not sustained any loss for regular tax purposes. He presumably should be entitled to the benefit of the previously disallowed AMT deduction, but this conclusion is not at all clear under the language of proposed § 56(b)(2)(B).

the Tax Section believes that two general principles would greatly improve the comprehensibility and fairness of these rules. First, a unified method for recognizing suspended losses should be employed. Second, as to all "timing" preferences it seems appropriate to allow deduction for AMT purposes of the suspended amount upon any ultimate disposition of the subject property, regardless of whether a loss is recognized. Although various systems could be used to satisfy these two objectives, perhaps the simplest would be one based upon AMT basis adjustments for all activities. Thus, depreciable assets, technological assets (created through § 174 expenditures), interests in limited partnerships creating losses and other AMT assets would all have a separate AMT basis, which basis would govern the calculation of gain or loss upon disposition.

Furthermore, the interpretative difficulties discussed above relate only to internal consistency within the AMT system. All of these difficulties are compounded when one considers the possibility that a taxpayer may be subject to the AMT regime in one year and to the regular tax in a later year. This subject is discussed in somewhat greater detail below in several contexts.

Passive Activity Losses

Perhaps the most controversial feature of the

proposed AMT provisions is the passive activity loss rule. Because of the broad significance of this rule, this report will first discuss whether the rule is appropriate as a policy matter, and then will turn to several more technical points.

Policy Considerations. Most Congressional attempts to constrain perceived tax shelter abuses in recent years have focused upon some form of "at risk" rule. The general spirit underlying those attempts has been that a taxpayer should not be permitted to reduce his tax liability through tax losses if there is no legal or economic certainty that the loss will ever truly be realized in an economic sense. The new rule of proposed § 58(b), however, rests upon a different theory for disallowance. Under this theory, which is said to be justified by analogy to treatment of C corporation shareholders,* a taxpayer's entitlement to tax losses would depend not upon whether the loss has been or will be truly realized, in an economic sense, but upon the degree of the taxpayer's active involvement in the enterprise.

For example, suppose that taxpayer A agrees to become a partner with B in a retail home computer sales business. A contributes $200,000 and B contributes $50,000, all in cash. A and B enter into a partnership agreement

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* Committee Report at 321.

pursuant to which profits and losses will be allocated to A and B in the ratio of 4 to 1 until cumulative profits equal $250,000, and 50/50 thereafter. It is agreed as a business matter that B will be solely responsible for managing the business, A's participation in effect being limited to the contribution of risk capital; accordingly, B is the sole general partner, and A is a limited partner. Assume further that the business is unsuccessful in its first year because of unfavorable market conditions, and that the partnership is forced to sell its inventory at a loss, producing a net loss for the taxable year of $100,000. Because the partnership agreement allocates more than 35% of the losses to the limited partner, the partnership is a "tax shelter" for purposes of proposed § 58(b)(2)(B). Accordingly, $30,000 of A's $80,000 share of the loss would be disallowed for AMT purposes.

The Tax Section questions whether there is a sound theoretical basis for this conclusion, which represents a departure from the principles of existing law. Under these facts A has actually suffered an out of pocket loss from the operation of an active business (which most persons would be quite surprised to hear characterized as a "tax shelter") but is not allowed to recognize all of that loss currently for AMT

purposes.* Admittedly, if the business were totally abandoned in a later year, A would then be entitled to recognize the loss. Nonetheless, the Tax Section doubts that the current disallowance in cases such as this represents sound tax policy, where the reason for disallowance is simply that A was not directly active in the enterprise. Rather, the Tax Section believes that the proper focus for disallowance criteria is within the context of those which the law has already developed, i.e., the "at risk" criteria, § 183, § 704(d), the substantial economic effect rules etc.

Relation to Other Preference Items. A related criticism of the passive activity loss rule is that it appears to duplicate the general effect of the numerous specific AMT income calculation and preference rules which are set forth elsewhere. In the process of duplicating those rules, however, as discussed below, the passive activity loss rule introduces the additional uncertainty of several terms of art which will not and cannot be defined with substantial precision. In addition, because of the rule requiring all passive loss activities to be netted against one another, the rule would prevent a taxpayer from knowing until the end of

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* Even if this partnership were not characterized as a "tax shelter," the result would be the same if A were a general partner who contributed $50,000 in cash and were personally liable on a bank loan of $150,000.

the year what the effect of any particular transaction within the year would be. The Tax Section believes, for the reasons discussed above, that the theoretical basis for disallowing a loss merely because of a taxpayer's passive role with relation to the activity is dubious. Accordingly, the Tax Section recommends that Congress eliminate the passive activity loss rule per se, and instead utilize the approach which has been utilized in the past, i.e., specific modification of the offending provisions, or failing that, specific designation as preference items of tax benefits which Congress wishes to be a part of the regular income tax law but not allowable for AMT purposes.

Cash Basis Definition. Application of the proposed excess passive activity loss rule, as well as the excess farm loss rule, would depend in part upon a determination of a taxpayer's "cash basis" in an activity. The definition of this term, which is similar to that used in § 461(i) of the Code, is set forth in proposed § 58(c)(1)(A). It would exclude, in the case of a partnership investment, any amount borrowed by the taxpayer-partner, even if there is full personal recourse, if the borrowing "was arranged by the partnership or by any person who participated in the organization, sale, or management of the partnership [or persons related to the foregoing]." The Tax Section believes that a taxpayer's

entitlement to deductions from an activity are appropriately limited by the existing basis and "at risk" rules, which are grounded in the economic and legal reality of whether or not the taxpayer faces an ultimate personal exposure to a liability, rather than upon the accident of what persons or their affiliates may have "arranged" the borrowing. Again, because of the number of taxpayers potentially affected, it is no solace that this rule would apply only for purposes of the AMT.

Other Definitional Issues. The excess passive activity loss rule would introduce into the law several new concepts which, until clarified by detailed regulations and case law development would be exceedingly difficult to define and correspondingly difficult for large numbers of taxpayers, their advisors and the IRS to comprehend. One clear example is the definition of "materially participates" under proposed § 58(b)(3)(B)(i). It is relatively easy to conclude that a limited partner does not materially participate in an activity.* Where a taxpayer owns property directly and employs an agent to manage it, however, one can imagine an

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* As drafted, proposed § 58(b)(3)(C) would appear to have the unintended effect of treating losses allocated to a taxpayer as a limited partner as passive activity losses, even if the taxpayer also materially participates in the activity by virtue of acting as a general partner or providing substantial personal services in connection with the activity.

endless variety of factual situations which present difficult questions of materiality.

A somewhat narrower definitional problem lies in the definition of "passive activity" in § 58(b)(3)(A). That term is defined as any activity if a substantial portion of its income is from a trade or business. This is a rather unfortunate choice of words, because in other parts of the tax law a "trade or business" is generally thought to be the opposite of a passive activity. This choice of words seems particularly unnecessary in view of other parts of existing law which already contain definitions of similar concepts. Perhaps the best example is the term "limited business interest" under proposed § 163(d). Consolidation of these provisions would be a significant simplification.

Summary of Passive Activity Losses. In summary, the Tax Section believes that the passive activity loss rule as contained in the Bill would add substantial complexity to the law without producing any substantial benefit. It is difficult to think of a situation which is obviously abusive, which would be covered by the excess passive activity loss rule and which would not be covered by the other tax preference and AMT accounting rules, not to mention the sundry other statutory and judicial anti-tax-shelter weapons now available. Accordingly, the Tax Section recommends either

that the AMT rules specifically designate those items which will be treated as preference items, or that the overall mechanism be radically altered in favor of a greatly simplified system.

Excess Farm Losses

The excess farm loss rules in proposed § 58(a) suffer from the same general criticisms discussed above in the context of passive activity losses: the rules represent a radical departure from the approach of current law, are overly complicated, and would appear to duplicate purposes served by other regular tax and AMT provisions (including the proposed passive activity loss rule) that seek to limit tax shelter activity. Accordingly, our recommendation either to designate specifically those items to be treated as tax preferences or to adopt a much simpler AMT scheme applies equally to losses from "tax shelter farm activities." At the least, to avoid unnecessary complexity, we would suggest that excess farm losses be treated with passive activity losses generally.

Nonessential Function Bonds

Proposed § 57(a)(6) treats interest earned on tax-exempt "nonessential function" bonds as an AMT preference for individuals and corporations. The inclusion of this item in this form deserves comment on a number of levels. First, why

are tax-exempt bonds targeted, while other tax favored items (e.g., fringe benefits) are not? Second, assuming for the moment that the goal of minimum tax is to define economic income and ensure that all taxpayers pay some tax on economic income, the Tax Section questions whether there is any real logic to stopping at "nonessential function" bonds. In their current form, the AMT proposals would continue to permit taxpayers to earn tax-free income on any obligation qualifying under the bill as an essential function bond. An argument might be made for permitting such treatment on the basis of the preferred status of government projects and activities financed with "essential function" bonds. However, such an argument credits the somewhat artificial distinctions between "essential" and "nonessential" bonds drawn in the Bill with more substance than is deserved. The nonessential function bonds that would be subject to the AMT include bonds which finance some of the most essential and expensive local services, including, among others, facilities for the furnishing of water to the general public, sewer and solid-waste disposal facilities, and schools or hospitals operated by non-profit organizations. On balance, the Tax Section does not endorse the proposed AMT's half-hearted incursion into the delicate question of repealing § 103. If Congress ultimately deems it necessary to include interest on such bonds as an AMT

preference in order to fulfill the AMT purpose of "requiring taxpayers with substantial economic income to pay some tax," the Tax Section would recommend that tax-exempt interest on "essential" function bonds be included as well.

Foreign Earned Income Exclusion

Under current law, U.S. citizens or residents who live and work abroad and satisfy certain foreign residence tests may exclude from gross income up to $80,000 a year of their foreign earned income.* The ceiling on excludable foreign earned income is frozen at $80,000 through 1987, and thereafter is scheduled to increase by $5,000 each year up to a maximum of $95,000 for tax years beginning in or after 1990.**

The Bill attacks the foreign earned income exclusion contained in § 911 of the Code on two fronts: § 644 of the Bill would reduce the amount of excludable foreign income to a permanent maximum amount of $75,000, and, under the AMT provisions, that $75,000 (minus deductions disallowed for regular tax purposes pursuant to § 911(d)(6)) would be treated as a preference. The taxpayer would be permitted to credit foreign taxes paid against AMT liability.

The Tax Section questions the wisdom of the Bill's

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* Section 911(a)(1) of the Code. Such taxpayers may also exclude their foreign housing costs in excess of a specified amount under § 911(a)(2) of the Code. The AMT proposal would not affect the housing cost provision.

** The Economic Recovery Act of 1981 had scheduled such increases to begin in 1984. The Tax Reform Act of 1984 delayed the implementation of this provision, and a number of other provisions, to 1988.

treatment of the exclusion for foreign earned income in light of the policy reasons for § 911 of the Code. Section 911 is designed to encourage Americans to work abroad and promote the purchase of U.S. goods and services as well as to make U.S. business more competitive in foreign markets by preventing the employment of Americans abroad from being a prohibitive expense.* This policy has kept some version of the current exclusion in the Code for 45 years.

The Ways and Means Committee report does not indicate an abandonment of the policy underlying § 911 as a reason for change, and the cap on excludable income would appear to be sufficient to prevent § 911 from being used by high income individuals to avoid U.S. taxes. So what function are these provisions affecting § 911 performing? It would appear that the Bill's double-barrelled attack on § 911 is intended as a revenue raiser.** However, even if some policy

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* S. Rep. No. 144, 97th Cong., 1st Sess. 35-36 (1981).

** It should be noted that the Administration's tax reform proposals would not have affected § 911 either directly or by including excludable amounts as an AMT preference. The original option paper developed for the use of the House Ways and Means Committee during markup (the "Rostenkowski option") included a $50,000 ceiling on excludable income and inclusion of the excluded amount as an AMT preference. The Rostenkowski option was specifically formulated to revise objectionable features of the Administration's proposal while arriving at the same revenue figure. Treasury voiced its objections to the § 911 proposals, but the House Ways and Means Task Force assigned to foreign issues agreed only to increase the ceiling

objectives must sometimes give way to a need for revenue, it is not clear that these proposals would enhance revenues.

In the case of U.S. taxpayers working in most OECD and treaty countries, the foreign tax credit may be sufficient to offset any increased U.S. tax liability, which would protect the taxpayer but would net nothing for the Treasury. Where there are insufficient foreign tax credits generated to offset the AMT cost, the many U.S. businesses that provide cost equalization payments (usually including tax protection) to their expatriate American employees will bear the burden of higher tax costs. The result may be both an offset effect on Treasury revenues (because of higher deductions for salaries) and a detrimental effect on competitiveness of businesses abroad.

In addition to the lack of revenue to be gained from the provision and the possible detrimental effects on our trade position, including the § 911 exclusion as an AMT preference would make computation of cost equalization payments more difficult for those employers who offer tax protection, and would make the preparation of U.S. tax returns for Americans abroad, which already involve a number of special U.S. provisions and which interact with foreign tax returns,

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to $75,000, and the AMT Task Force retained the exclusion as a preference item.

even more complex.

In light of these criticisms and given the fact that the proposed AMT does not strive to include all items that are tax-exempt or otherwise excluded from regular taxable income, the decision to include the § 911 exclusion as an AMT preference would appear to be a particularly poor one. Accordingly, the Tax Section recommends that if Congress continues to find valid policy reasons for retaining § 911 in the regular tax scheme, the foreign earned income exclusion not be included as an AMT preference item.

Other Technical and Drafting Comments

With respect to the remainder of these comments, we note that complexity breeds technical problems and that others will undoubtedly discover numerous technical flaws in the AMT proposals in addition to those identified here. Accordingly, these comments are not intended to be comprehensive, but instead to point to a few of the anomalies that we have encountered.

Restrictions on Interest Deductibility. The restrictions on interest deductibility contained in proposed §§ 56(d) (AMT) and § 163(d) (regular tax) are generally similar. Both would allow deductions for interest related to the taxpayer's ownership of personal residences, and for other interest to the extent it does not exceed the taxpayer's net

investment income. These two provisions are sufficiently divergent, however, so as to require taxpayers to perform two sets of computations. Moreover, interest not deductible under one provision might be deductible under the other. For example, proposed § 163(d) would allow a deduction only for interest on indebtedness secured by the taxpayer's principal residence regardless of the reason for which the indebtedness was incurred, whereas proposed § 56(d) would permit a deduction only for interest on indebtedness incurred in acquiring, constructing or rehabilitating the residences, whether or not secured. (See the discussion of "qualified housing interest" below.) As another example, net investment income under proposed § 56(d) would include the untaxed portion of any long-term capital gains, but these amounts would be excluded from net investment income under proposed Section 163(d). There is no articulated rationale for the divergences between proposed §§ 56(d) and 163(d). Rather, each section appears to have been drafted without reference to the other. As a minor but definite contribution to tax simplification and rationality, identical standards should be employed in both sections, notwithstanding that, as proposed, the limits of proposed § 163(d) are phased in over ten years.

"Qualified Housing Interest." Proposed § 56(d)(4)(A) defines "qualified housing interest" for pur-

poses of the AMT interest expense limitations by reference to indebtedness "incurred in acquiring, constructing, or substantially rehabilitating" a personal residence. This definition may operate unfairly towards a taxpayer who refinances a home mortgage loan which qualifies within this definition. Refinancings are common in today's interest rate environment, in which many taxpayers are refinancing old home mortgages simply to obtain the benefit of lower interest rates. The correction of this problem should be carefully drafted so as to avoid including indebtedness which is greater in principal amount than that which is being refinanced (unless otherwise justified by a substantial rehabilitation). This concern could be rectified by inserting new "flush language" at the end of proposed § 56(d)(4)(A) to read as follows:

> "The term 'qualified housing interest' shall also include interest which is paid or accrued during the taxable year on indebtedness incurred to replace any indebtedness incurred, or temporary initial financing utilized,* in acquiring, constructing, or substantially rehabilitating any property described in the clauses (i) or (ii) of this subparagraph 4(A) or in this sentence, but only to the extent of the principal amount of such refinanced amount."

Incentive Stock Options. One example of the inadequate operation of the AMT credit provisions of the Bill occurs in the case of incentive stock options ("ISO"). Con-

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* This language is based upon similar language in § 103A(j)(1)(B)(ii).

sider a taxpayer who exercises an ISO with a price of $100, at a time when the value of the optioned stock is $200. Under the Bill, the taxpayer would be required to include $100 in AMT income, which, if the taxpayer is subject to the AMT in the year that the option is exercised, would result in AMT liability of $25. When the taxpayer ultimately sells the stock, say, at the same price of $200, its basis will not reflect the previous inclusion of $100 in AMT income, so that the taxpayer would have a capital gain of $100. The resulting tax liability would be $22 under either the regular income tax or the AMT, for a total tax liability of $47 in respect of the exercise of the ISO and the sale of the underlying stock, representing a double tax on the same $100 income item.*

However, because the $25 AMT liability would be available as a credit against regular income tax in any succeeding year in which the taxpayer is subject to regular income tax (regardless of when the stock is sold) the taxpayer's net tax liability could be reduced to $22, at least over time, since the credit would not apply to AMT liability. The adequacy of this adjustment obviously would depend on when the taxpayer becomes subject to regular tax. The taxpayer who disposes of

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* This represents a tax rate of 47%, compared to a 38% regular tax rate on ordinary income. The inclusion would also not give rise to any employer deduction.

the stock in the first regular tax year after exercise of the ISO during an AMT year will receive the double-tax ameliorating credit in the year of sale. We believe this is the correct result. If the taxpayer is subject to the AMT for a number of consecutive years, however, he could incur a total tax liability of $47 in the early years without receiving the benefit of the $25 credit until many years later. The taxpayer who remains indefinitely in the AMT mode would never obtain the benefit of the mechanism designed to ameliorate the double tax effect. Accordingly, in the case of the treatment of ISO's the AMT credit would operate somewhat awkwardly at best, and inequitably in the case of the taxpayer who finds himself in the AMT mode over a longer period of time. We believe that the more appropriate remedy would be a basis adjustment for the underlying stock at the time of exercise of the ISO.*

Charitable Contributions. As described above, proposed §§ 57(a)(2) and 57(b) provide in effect for the inclusion in the AMT base of appreciation on charitable gifts of capital gain property as if the property in question had been sold. This inclusion is somewhat anomalous in that if the property in question were sold, triggering a long term

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* Note that this item would be covered by the basis adjustment recommended above.

capital gain, the AMT inclusion would be adjusted so as to prevent taxation at a rate higher than 22%. A similar adjustment should be applied to the appreciation on capital gain property given to a charity.

## IV. EFFECTIVE DATES AND TRANSITION RULES

Another general concern of the Tax Section is retroactive application of the AMT to investments made prior to the time when these proposals were publicly announced. This concern (among others) has recently been articulated in a special report of the New York State Bar Association Tax Section, Special Committee on Effective Dates of H.R. 3838, "Effective Dates of Tax Reform Legislation," (February 19, 1986), pp. 33 - 34, and the comments included in that report will only be summarized here. The Tax Section in general strongly supports prospective general effective dates and recommends that the proposed AMT provisions be made generally applicable on or after the date of enactment. On a more particular level, the Tax Section recommends that the application of the passive activity loss rules be modified so as not to apply to investments made prior to enactment, or at the least, so as not to affect adversely investments made prior to the Bill's current 1985 effective dates.

The inequity of the retroactive effect of the passive activity loss rules is compounded by the fact that the Bill would protect some pre-1985 investments from the application of new AMT rules, notably accelerated depreciation for non-passive investors. For example, a corporate owner of leased personal property placed in service in 1985 would not

be required under the proposed AMT to include any amount as a preference; an active participant individual owner of the same property would include accelerated depreciation as a preference only to the extent required by present law AMT provisions known to the taxpayer when he made the investment. A limited partner investor in the same property, however, would be subject to the further limitations of the "passive activity loss" rules, which would have the effect of retroactive application in the sense that the investment was originally made in reliance upon then existing law and may not have been at all abusive. The Tax Section believes that such a result is not consistent with fair taxation policy.

## V. CONCLUSION

The AMT concept is not new, but the Bill would cast the AMT in a new role, sharply altered from its present role as a modest backstop to the regular tax rules. Under the Bill the AMT would become a major new tax system in and of itself, as a result of (i) a drop in the maximum marginal regular tax rate; (ii) an increase in the AMT rate; and (iii) the addition of many new items of tax preference.

This new, parallel tax system would represent neither simplification nor reform. Instead, the proposed AMT would greatly enhance the complexity of the tax laws for a major segment of the taxpaying public and would tend further to obscure, on practical and policy levels, the types of activities which are encouraged by Congress and to what degree.

Perhaps even more disturbing, new, controversial and difficult concepts have been included in the proposal without adequate policy consideration or public understanding. These changes are apparently justified by the view that they are "only" for AMT purposes.

We are mindful of the perceived usefulness of some form of minimum tax, but we believe that these proposed changes to the current AMT are steps in the wrong direction. A simpler approach that would not create a second tax code is

needed. Failing that, we urge reconsideration of a number of the proposed changes which, as discussed above, seem to be misplaced or unfair. Finally, we urge in any event that the present ratio of the regular tax rate to the AMT rate be retained, in order to prevent the creation of a pervasive second tax system and to preserve the proper role of a minimum tax as a backup to the regular tax laws.