REPORT # 534

TAX SECTION

New York State Bar Association

Technical Comments on H.R. 3838 as Passed by the
United States Senate
on June 24, 1986

July 11, 1986

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Attached letter dated 7/15/86 enclosing report of the Personal Income Committee regarding technical comments on H.R. 3838 as passed by the U.S. Senate on 6/24/86 sent to the following:

The Honorable Dan Rostenkowski
cc: The Honorable John J. Duncan
Robert J. Leonard, Esq.

The Honorable Bob Packwood
Chairman
Senate Finance Committee
cc: The Honorable Russell B. Long
John Colvin, Esq.

The Honorable J. Roger Mentz
Assistant Secretary (Tax Policy)
Department of the Treasury

The Honorable David H. Brockway
Chief of Staff
Joint Committee on Taxation

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July 15, 1986

The Honorable Dan Rostenkowski
2232 Rayburn Building
Washington, DC 20515

Dear Representative Rostenkowski:

The enclosed report, principally prepared by the Committee on Personal Income sets forth the views Bar Association on Certain provisions of the Tax Reform Act of 1986, H.R. 3838, as passed by the United States Senate.

The report calls attention to the following items among others:

1. Unexpected acceleration of the phase-in of the proposed passive loss limitation rules that results from their interaction with the new investment interest limitations;

2. The breadth of the proposed disallowance of miscellaneous itemized deductions, which can lead to taxation of gross income contrary to traditional tax principles;

3. Difficulties raised by the proposed tax shelter user issues.

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I hope the report proves useful to you.

Sincerely,

Richard G. Cohen
Chairman

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

REPORT #534

Technical Comments on H.R. 3838 as Passed by the United States Senate on June 24, 1986

July 11, 1986

New York State Bar Association
Tax Section

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

Technical Comments on H.R. 3838 as Passed by the United States Senate on June 24, 1986

Introduction

This report sets forth technical comments on those provisions of the Tax Reform Act of 1986, H.R. 3838, as passed by the United States Senate (the "Bill") that relate to the personal income tax.[1/]

Summary

1. Bill Sections 101 and 103. We suggest that the provisions phasing out the 15% rate and the personal exemption make clear that the phase-outs take place sequentially, as was apparently intended. As currently drafted, in certain cases the phase-outs may overlap, resulting in a 10% increase in the marginal rate for certain income.

1/ This report was prepared by Steven C. Todrys and Patricia Geoghegan, Co-Chairmen of the Committee on Personal Income, Alvin D. Knott and Thomas M. Melone.

References in this report to the "Senate Report" are to the Report of the Committee on Finance of the United States Senate, S. Rept. 99-313, 99th Cong., 2d Sess. (May 29, 1986).

2. Bill Section 132. In addition to a few technical comments, we note that proposed Section 280H disallows deductions associated with income-producing activities, such as investment advisory fees and management fees for portfolio accounts. While the Tax Section is aware of the administrative and enforcement problems connected with those deductions, the disallowance of deductions directly related to income-producing activities results in a mismeasuring of net income.

3. Bill Section 521. The Tax Section believes that further guidance is needed as to the types of real estate transactions subject to information reporting and the reporting responsibility of persons participating in the transaction.

4. Bill Section 531. The Tax Section thinks that proposed Section 6662, which imposes a tax shelter user fee, is both a bad idea and poorly drafted.

5. Bill Sections 1401 and 1421. In addition to its technical comments, the Tax Section notes that the phase-in of the limitation on passive activity losses, coupled with the phase-in of the limitation on the deduction of investment interest expense, effectively accelerates the phase-in of both provisions.

6. Bill Section 1601. The Tax Section believes that income attributed to a parent should be taken into

account in determining deductions of the parent based upon adjusted gross income. In addition, consideration should be given to whether the allocation of income from a nonsegregated account should be permitted and to whether the provision should apply to gifts made prior to enactment.

Discussion

1. Bill Sections 101 and 103--Rate Reductions and Increase in Personal Exemptions

The phase-out of the 15% rate and the personal exemption amount are apparently intended to occur sequentially. For married individuals filing jointly, the 15% rate is phased out between $75,000 and $145,320 of adjusted gross income ("AGI") and the personal exemption is phased out for AGI in excess of $145,320. However, because an alternate method for phasing out the 15% rate is based upon taxable income, the phase-outs may overlap, resulting in an increase in marginal rate of tax for certain income amounts of 10% (as opposed to the intended 5%).

For example, assume a married taxpayer filing jointly has AGI of $145,320 and itemized deductions of $116,020. Since his taxable income will be $29,300, the phase-out provisions will not result in additional tax. Assume next that the taxpayer makes $5,000 more for the year, or $150,320, and still has $116,020 of itemized deductions. Since his taxable income will be $34,300, the adjustment resulting from the phase-out of the 15% rate will be 5% of the difference between $34,300 and $29,300 or $250. However, since his AGI will be $5,000 over the AGI threshold of $145,320 for phasing out the personal exemption, the phase-out will produce an additional tax of $250. Thus, the additional tax would be $500, or 10% of the additional $5,000 income.

2. Bill Section 132--Miscellaneous Itemized Deductions Disallowed

Section 132 of the Bill disallows the miscellaneous deductions under present law that are claimed on Schedule A, lines 20-23 of Form 1040 other than (a) certain business expenses for handicapped employees, (b) the deduction for certain costs of adopting children with special needs, (c) the deduction for estate tax payable on income in respect of a decedent, (d) the deduction for gambling losses up to, but not exceeding, gambling income and (e) the adjustment deduction when a taxpayer restores to income certain amounts held under claim of right.

The drafters intend to eliminate, among other things,

(a) most of the deductions made available by Code Section 212,

(b) many deductions currently available to taxpayers under Section 162 in connection with the trade or business of performing services as an employee, and

(c) the hobby loss deduction (permitting deductions not in excess of the income produced by the activity) currently available under Code Section 183.

Proposed Section 280H is intended to eliminate deductions that are largely personal in nature, such as fees paid to tax return preparers, or that are susceptible to abuse, such as costs associated with the use of personal computers. Many of the items are small and expensive to audit. But proposed Section 280H is so broad that it produces results contrary to one of the principles underlying our income tax system, namely, that the income tax be based on net rather than gross income.

Proposed Section 280H virtually repeals Section 212, which was enacted in 1942 in response to the Supreme Court's ruling in Higgins v, Commissioner, 313 U.S. 212 (1941). In Higgins the Court held that a taxpayer who devoted a substantial part of his time to the management of his investments and incurred substantial expenses in connection therewith could not deduct those expenses. Realizing that such a result was unfair and contrary to the notion that taxation should be based on net income, Congress enacted Section 212. Part of the effect of proposed Section 280H will be to restore what the Supreme Court has described as

> "the inequity inherent in the disallowance [by the Higgins case] of expense deductions in respect of such profit-seeking activities, the income from which [is] nonetheless taxable".[2/]

Proposed Section 280H goes beyond the disallowance of personal deductions and disallows expenses that should be treated as offsets against income. The effect will be to tax more than the taxpayer's economic income:

(a) A taxpayer who pays a broker or trustee to manage his portfolio would now be taxed on the gross income of the portfolio without reduction for broker or trustee fees.

(b) An individual holder of mortgage-backed securities normally owns an interest in a grantor trust that holds a pool of mortgages. He includes in his gross income his proportionate share of the gross income of the trust and deducts under Section 212 his proportionate share of the expenses of the trust. The net yields to such certificate-holders will be reduced once the

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[2/] U.S. v. Gilmore, 372 U.S. 39, 45 (1963).

deductibility of expenses incurred in the operation of the trust is eliminated.[3/]

(c) Under certain dividend reinvestment plans a shareholder-participant designates a third party to act as his agent to receive dividends and to reinvest the dividends in stock of the corporation. Service charges and operating expenses of the agent are paid by the corporation. The payment of those expenses constitutes a dividend to each shareholder-participant and is included in his gross income. Under proposed Section 280H the shareholder-participant would not be entitled to the offsetting deduction under Section 212 to which he is currently entitled.[4/]

(d) A spouse who pays a lawyer to collect past-due alimony, an employee who sues his employer for wrongful discharge, a tort victim who sues for punitive damages and a taxpayer who sues for a state tax refund will, under proposed Section 280H, be taxed on the gross amount collected without reduction for the legal fees incurred.

[3/] The result may be different under the provisions of the Bill that set forth a new mechanism for issuing mortgage-backed securities.

[4/] See private letter ruling 7830104, April 28, 1978, for an example of such a dividend reinvestment plan.

If the successful litigant is also awarded attorneys' fees, the amount of the fees will apparently also be includable in gross income without an offsetting deduction.

(e) Since proposed Section 280H disallows many employee trade-or-business expenses, actors and athletes will be taxed on their gross wages and salaries without reduction for the fees paid to their agents.[5/]

By taxing gross rather than net income, proposed Section 280H will lead to unintended economic results, discrimination against salaried employees and difficulties of administration:

(a) Taxpayers will naturally redirect their investments away from situations in which nondeductible income-producing expenses arise toward situations that produce more reasonable after-tax results. For example, it will make more sense for a taxpayer to invest in a mutual fund (where expenses are offset against income at the fund level) than to pay a broker to manage his savings.

[5/] Proposed Section 280H does not reach employer-reimbursed expenses (which remain an adjustment to gross income under Code Section 62) or employee travel, transportation and outside salesmen expenses (which under the Bill will no longer be treated as an adjustment to gross income and will be deductible only to the extent they exceed 1% of adjusted gross income)

(b) An ongoing structural problem in the tax system--the dichotomy between self-employed individuals and W-2 wage-earners--will be aggravated. Under proposed Section 280H even taxpayers who itemize deductions will be unable to deduct items that their self-employed counterparts will be able to deduct. For example, law firm partners will be able to deduct their bar association membership fees while law firm associates (and in-house counsel) will not.

(c) We can expect to see a flood of litigation to determine whether activities are merely aimed at producing income or rise to the level of a trade or business. Many taxpayers have up to now been indifferent about the theoretical classification of activities that produce a profit. But they will become more interested in establishing the legal boundaries of the two categories once they discover that income-producing activities are taxed on a gross basis while trade-or-business activities are taxed on a net basis.

The expenses described in the above examples should be distinguished from other currently deductible expenses that have characteristics of a personal expense and do not raise the possibility of taxation of gross income.

For example, perhaps payments for services and expenses of brokers, trustees, agents and other entities engaged in rendering investment services or finding and negotiating employment contracts should remain deductible.

Certain itemized deductions that are disallowed under proposed Section 280H and which would have been deductible under Section 212 should, at least, be capitalizable so that at the time of a sale the overall amount of income subject to tax from the asset to which the expense relates would be on a net basis (e.g., expenses of entities (such as grantor trusts) issuing mortgage-backed secure-ties).

Proposed Section 280H also lacks adequate transition rules. In 1984 Congress, in Section 280F, tightened the rules for certain “listed property”. Certain deductions were specifically allowed, such as depreciation deductions for computers (and other listed property) used in connection with Section 212 activities or certain Section 162 activities (generally as an employee). Even though Section 280F reduced the amount of the deductions it nevertheless allowed them. Taxpayers who acted in reliance on those rules (even those who are entitled to the slower depreciation under Section 280F) will now have their deductions disallowed for taxable years beginning in 1987.

Finally, the new provision apparently contains at least one drafting error which is its failure either to permit taxpayers to claim the new standard deduction or, alternatively, to restrict the application of proposed Section 280H to taxpayers who itemize their deductions.[6/]

3. Bill Section 135--Repeal of State and Local Sales Tax Deduction

The Bill will amend Section 164 of the Code to eliminate (except for individuals residing in states with little or no state income tax) the deduction for state and local sales taxes not incurred in a trade or business or an activity for the production of income.

We note that the Bill as amended by Amendment No. 2104 provides that any tax paid acquiring or disposing of property for which no deduction is allowed can be included in the basis of the property or deducted against the amount realized on disposition of the property. The Tax Section strongly supports the amendment.

[6/] We note that last-minute amendments to the Bill have restored the deduction for amortizable bond premium under Section 171 of the Code and have revised proposed Section 280H(a)(l) to permit any deduction allowable in arriving at adjusted gross income.

4. Bill Section 521--Requirement of Reporting for Real Estate Transactions

The Bill adds a new subsection (e) to Section 6045 of the Code (relating to information returns of brokers) which requires the reporting of real estate transactions. In addition, a backup withholding system is provided.

What is a real estate transaction? One might conclude, based upon the Senate Report and the Bill's definition of real estate brokers that a "real estate transaction" only includes taxable transactions involving the sale of real property. It is unclear, however, whether other real estate-related transactions (such as leases, subleases, lease surrenders, sale contracts, contract assignments and mortgage refinancings) are covered by the term "real estate transaction". We suggest that the text of the Bill be clarified to resolve the uncertainty and avoid endless requests for administrative interpretations or rulings.

The Bill defines "real estate brokers" as certain persons in a descending order of priority. Although the Bill is not clear as to what the words "in the following order" mean, the Senate Report does add some clarification. It is not clear, however, what the result is when a "broker" high on the priority list fails to file a return. Is the "broker" that is listed next in line liable to file a return or required to verify that the first "broker" has filed a return and that the return is an adequate one?

Since the Bill takes effect prior to the issuance of regulations, the Bill should define more clearly the responsibilities of lower-priority brokers or preferably the effective date should be postponed until detailed regulations are issued. In the absence of specific rules, needless confusion will impede commercial and personal real estate transactions and the real estate industry will be unreasonably burdened. The burden should instead be placed on the Internal Revenue Service to issue a clear set of rules.

5. Bill Section 531--Tax Shelter User Fee

New Section 6662 imposes a nondeductible tax shelter user fee of 1% of losses claimed and 3% of credits claimed. The fee is intended to cover the cost to the Internal Revenue Service of administering the tax law as it applies to tax shelters.

The Tax Section feels strongly that the proposed tax shelter user fee provision is unworkable as a device for financing audits, excessive in light of the new and/or expanded limitations on passive losses, at-risk limitations and limitations on nonbusiness interest, unfair in imposing

a new penalty on transactions entered into long ago, and so badly drafted as to be virtually unintelligible.

As far as we are aware, Congress has not up to now been successful in identifying a stream of taxes to pay for specific tax administration activities. For example, the 2% (formerly 4%) tax on private foundations was designed with a similar goal but we understand that Congress has never appropriated the funds as a means a financing the audit of private foundations.

Moreover, the Bill already introduces many disincentives with respect to tax shelter activities. The Section questions whether it is necessary to add another layer of complexity. As an example of the complicated questions raised by the proposed provision, we note that it is unclear whether losses suspended under the passive loss limitation provisions are subject to the tax shelter user fee.

The remainder of this section will cover some of the technical problems of the proposed provision, although we recommend scrapping it entirely.

The tax shelter user fee is triggered in any taxable year in which a taxpayer claims a “substantial cumulative net loss” from a tax shelter. A taxpayer's cumulative net loss is substantial if, when added to 300% of the taxpayer's cumulative tax credits, it exceeds the investment

base (as defined in Section 6111(c)(3)) plus the income received from the shelter. "Cumulative net loss" is defined as the aggregate amount of net losses attributable to the shelter for all periods up to (and including) the close of the taxable year.

Proposed Section 6662(a) should be redrafted to clearly refer to the triggering event:

> "(a) ADDITION TO TAX. - In any taxable year in which a person filing a return with respect to tax imposed by subtitle A has a substantial cumulative net loss with respect to any tax shelter, there shall be added to the tax an amount equal to the tax shelter fee." (Changes from proposed Section 6662(a) as currently drafted have been underscored.)[7/]

Subsection (b) of proposed Section 6662 is unclear in its treatment of net income derived from a tax shelter. The definition of cumulative net loss apparently aggregates only those taxable years of the shelter in which there is a net loss. Net income from any taxable year is an offset to cumulative net loss because it is added to the investment base for purposes of determining whether a cumulative net

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[7/] Proposed Section 6662(a) as currently drafted states:

> "(a) ADDITION TO TAX. - With respect to each tax shelter, if any person in filing a return with respect to tax imposed by subtitle A for any taxable year claims a substantial cumulative net loss for such taxable year, there shall be added to the tax an amount equal to the tax shelter user fee."

loss is substantial. To clarify that provision, the term "income" in subsection (b)(l) should be changed to "cumulative net income", which should be defined in the same manner as cumulative net loss (i.e., the aggregate of net income in all taxable years in which the tax shelter had net income). Alternatively, "cumulative net loss" could be defined to take into account taxable years in which there is net income, with the result that, in some years, the cumulative net loss could be negative.[8/] Such a change would obviously require that net income be excluded from the definition of a substantial cumulative net loss.

In addition, the definition of cumulative tax credits should take into account the amount of any credits recaptured.

Subsection (c) of proposed Section 6662 imposes a fee equal to the sum of 1% of the net losses plus 3% of the credits claimed by the taxpayer on his return for "any taxable year" attributable to the tax shelter (emphasis added). The suggestion of the statutory language, not contradicted in the Senate Report, is that, once the trigger event occurs, the fee is imposed on all losses and credits attributable to the shelter, including those from prior years.

[8/] There could still be a substantial cumulative net loss if 300% of the credits exceeded the negative cumulative net loss plus the investment base.

Further, the fee applies to the loss of the investment base and any net income, not only to losses in excess of such amounts. The Tax Section believes that the subsection must be redrafted to make clear whether the amount of the fee is based upon prior years' losses as well as the loss for the current year and whether the fee applies to disallowed or suspended losses.

Proposed Section 6662(c)(2) doubles the fee if it is not paid with the return, even if nonpayment is due to reasonable cause. We believe that a reasonable cause exception should be provided.

The tax shelter user fee is applicable to returns due after December 31, 1986, and, therefore, to tax shelter activities in 1986 and, for fiscal-year taxpayers, certain tax shelter activities in 1985. Moreover, net losses claimed in prior years are taken into account in determining whether a taxpayer has a substantial cumulative net loss and, presumably, are subject to the fee if subsection (c) is applied literally to net losses for any taxable year. If the fee must be imposed with respect to existing transactions, the Tax Section believes that the fee should at least not be imposed upon or determined with respect to net losses claimed on returns due prior to January 1, 1987, even if, in general, the determination of whether the fee is applicable in any particular year is determined with reference to net losses claimed in prior years.

6. Bill Section 1401 and 1421--Limitations on Losses and Credits from Passive Activities and Limitations on Deduction for Nonbusiness Interest

The Bill disallows losses realized by individuals from most passive activities, thus reducing the benefit of many tax shelters. On its face the provision is phased in with respect to pre-enactment interests over 5 years by disallowing only 35%, 60%, 80% and 90% of otherwise nondeductible losses for the next 4 years, respectively. In addition, the Bill disallows consumer interest and makes interest from certain passive activities subject to the investment interest limitation provisions. Those provisions are phased in under the same schedule as that applying to passive losses.

The primary problem with the passive activity loss rule is its interaction with the investment interest expense rule during the 5-year phase-in period. With respect to the coordination of those provisions the Senate Report states, at page 723:

> "In the first year after the effective date, for example, the investment interest limitation is applied and a portion of previously deductible investment interest is disallowed. That disallowed interest is not disallowed again under the passive loss rule, but only the remaining portion of interest (not disallowed due to the interest limitation phase-in) can be subject to disallowance under the phase-in of the passive loss rule."

If the two rules are intended to operate in the manner indicated in the Senate Report, the phase-in is substantially accelerated.

Example. A is a limited partner in partnership X. For 1987, A's share of X's income and expenses amounts to rental income of $6,000, operating expenses of $2,000, depreciation deductions of $4,000 and interest expense incurred on debt of the partnership of $4,000.

A's investment income will be zero ($6,000 - $2,000 of expenses and $4,000 of depreciation). He will have $4,000 of net investment interest expense and he will have $4,000 of passive net losses.

Under the investment interest expense phase-in rule, 35% of A's investment interest expense of $4,000 will be disallowed, thus leaving a deduction of $2,600 and resulting in a passive activity loss for 1987 of $2,600. Then 35% of the $2,600 passive activity loss will be disallowed under the passive activity loss rule resulting in a deductible loss of $1,690. In effect, the interaction of the two rules produces a 57.75% disallowance of the losses from the partnership as opposed to the advertised 35%.

If the partnership had the same income and expenses in 1988, the interaction of the two rules would produce an 84% disallowance of the losses from the partnership as opposed to the advertised 60%.

We question whether the accelerated disallowance caused by the interaction of the two rules was intended. It is not clear to us whether the increased revenue that would result was included in the revenue estimates or whether the revenue estimates were based on a disallowance of only 35% of passive partnership losses. In any case, it is fair to say that many people support the retroactive application of the passive loss provisions only on the assumption that the new limitations are being phased in on a 35%, 60%, 80% and 90% schedule rather than a 57.75%, 84%, 96%, etc., schedule.

In calculating the alternative minimum tax under the Bill, passive losses are also disallowed. There is not a phase-in of the disallowance, however. One hundred percent of passive losses are disallowed in calculating the alternative minimum tax for 1987. The Tax Section thinks that there should be a phase-in of the passive loss provisions under the alternative minimum tax as well as under the regular tax.

In addition to the phase-in, we have a number of technical comments.

(a) Proposed Section 469(b)(2), which describes the treatment of previously disallowed passive losses when an activity ceases to be a passive activity, should make

clear that it applies only to such previously suspended losses. As drafted, the provision could be interpreted more broadly to limit the deduction of losses incurred during the years the activity was not passive. We suggest changing the language to state "any deduction or credit allocable to such activity in prior taxable years".

(b) Proposed Section 469(c)(2)(B) refers to "the tax liability of the taxpayer allocated to all passive activities", but the provision does not indicate how that amount is to be determined. The Senate Report states that "the amount of tax attributable to net passive income is determined by comparing (i) the amount that the taxpayer would pay with regard to all income, with (ii) the amount that the taxpayer would pay with regard to taxable income other than net passive income (disregarding, in both cases, the effective credits)".[9] We recommend including the definition in the statute.

(c) We question whether proposed Section 469(c)(3)(A)(i), which excludes from passive activity income moss income from interest, dividends and royalties not derived in the ordinary course of a trade or business, should be amended to refer to net income from such sources.

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[9] Senate Report, pages 723-724.

We suggest that expenses associated with the production of such portfolio income, to the extent not disallowed by proposed Section 280H, should reduce portfolio income, not passive income.

(d) As a technical matter, the we recommend revising proposed Section 469(c)(3)(C) to read,

> "(C) PASSIVE ACTIVITY NOT PROPERTY HELD FOR INVESTMENT. - For purposes of subparagraph (a)(ii), any property used in a passive activity shall not be treated as property he ld for investment." (Changes from proposed Section 469 (c)(3)(C) as currently drafted have been underscored.)[10]

(e) Proposed Section 469(e)(1)(A) requires a taxpayer who disposes of his entire interest in a passive activity to first offset any suspended losses against gain on the disposition of his interest in the activity. We are concerned that the provision ignores character differences. The provision would require using ordinary suspended losses to offset capital gain on disposition. Even where capital gain and ordinary income are taxed at the same rate, the provision could defer the use of capital losses that otherwise would have offset capital gains.

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[10] The text currently states:

> "(C) PASSIVE ACTIVITY NOT PROPERTY HELD FOR INVESTMENT. - For purposes of subparagraph (a)(ii), any passive activity shall not be treated as held for investment."

(f) We believe that the effect on other sections of the Code of increasing a donee’s basis by the donor's suspended losses should be clarified. For example, where a partnership interest in a passive activity is disposed of by gift, the donee's basis in the interest will be stepped up by the passive activity losses allocable to the interest under proposed Section 469(g)(2). Section 743 will not, however, permit stepping up the basis of the underlying partnership assets even where a Section 754 election is in effect. Section 743 should perhaps be amended to permit stepping up the basis in a partnership's assets where a gift results in a step-up in the basis of a partnership interest under proposed Section 469(g)(2).

(g) Section 1421 of the Bill will enact a new Section 163(h) of the Code that will deny individuals a deduction for “consumer interest”. Proposed Section 163(h)(2)(B) provides an exception to the disallowance of consumer interest for “qualified residence interest”. Proposed Section 163(h)(3) defines “qualified residence interest” as “interest which is paid or accrued during the taxable year on indebtedness which is secured by any property which (at the time such interest is paid or accrued) is a qualified residence of the taxpayer”.

It is not clear what the result is if the interest is paid (by a cash-basis taxpayer) at the end of the year when the property is a qualified residence but relates to a period during which the property was not a qualified residence or, vice versa, if the interest is paid at a time when the property is not a qualified residence but relates to a period during which the property was a qualified residence.

(h) Section 1421 defines "consumer interest" as all deductible interest other than certain specified types of interest and defines "investment interest" as all deductible interest other than certain specified types of interest. The provisions would be easier to understand if each definition were not dependent on the other.

For example, consumer interest could be defined as all interest other than (i) qualified residence interest, (ii) interest allowable as a deduction in computing adjusted gross income which is not attributable to a limited business interest and (iii) investment interest. Investment interest could in turn be defined as (i) interest incurred in an activity described in Section 212 and (ii) interest allowable as a deduction in computing adjusted gross income which is attributable to a limited business interest.

Similarly, the definition of investment income would be more understandable if it were restructured to include

(A) the following amounts, whether or not they are derived from the conduct of a trade or business:

> (i) income derived from any interest in an activity in which the taxpayer does not materially participate (or in the case of any rental real estate activities, in which the taxpayer does not actively participate);
>
> (ii) income derived from any interest as a limited partner in a partnership (subject to exceptions); and
>
> (iii) Income derived from any interest of a lessor in property subject to a lease (under specified circumstances);

and (B) any other amount (but only to the extent such amount is not derived from the conduct of a trade or business) if such amount is

> (i) gross income from interest, dividends, rents or royalties;
>
> (ii) an amount treated as ordinary income under Section 1245, 1250 or 1254; or
>
> (iii) capital gain net income attributable to the disposition of property held for investment.

(i) The Tax Section questions whether Congress really intends to disallow interest paid by taxpayers on state and local tax deficiencies and interest paid by taxpayers on Federal tax deficiencies. If interest paid by taxpayers is nondeductible while interest paid by Federal, state and local governments on tax

overpayments is includible in income, taxpayers are in a particularly unfortunate position. Bill Section 511 expressly proposes that the Federal government pay interest on overpayments at a rate that is 1% lower than the interest rate paid by taxpayers on deficiencies. The Senate Report, at page 184, describes the effect of the new provision as a "one-percent differential". The differential would actually be significantly larger if the interest paid by taxpayers on tax deficiencies were not deductible.

7. Bill Section 1601 -- Unearned Income of Certain Minor Children

Section 1601 of the Bill would, in general, tax the unearned income of children under age 14 which is attributable to parental sources as if that income were the parents' income. The provision applies to income earned in 1987 and thereafter from parental gifts transferred prior to (as well as after) the date of enactment. We believe two changes would result in the provision's functioning more fairly.

First, although the provision would tax children on net parental-source unearned income as if that amount were included in the parents' taxable income, it would not take such income "into account in computing any deduction or credit of the parent". Proposed Section 1(i)(3). We believe it is unfair to tax children on parental-source unearned income as if it were the parents' income without giving the parent or the child the benefit of any reduction in tax that would result if such income were in fact the parents' income. For example, where deductions, such as charitable contributions, are limited by a particular percentage of adjusted gross income, including the parental-source unearned income in the

parents' income would increase the amounts that could be deducted. Those additional deductions should be allowed to the parent or the child.

Second, new Section 1(j)(5)(A) excludes from "net parental source unearned income" income attributable to any asset "if the entire amount of such asset is attributable to nonparental sources...." In the case of cash, which is completely fungible, we question whether it is necessary to segregate amounts given to children by their parents from amounts given to children by others in order for the income earned on the latter to be excludable.