REPORT #522

TAX SECTION

New York State Bar Association

1986 TAX REFORM ACT SEMINARS

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REPORT #545

NEW YORK STATE BAR ASSOCIATION

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1986 TAX REFORM ACT SEMINARS

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Individual Alternative Minimum Tax

OCTOBER 9, 1986

LIMITATIONS ON LOSSES FROM PASSIVE ACTIVITIES AND ON DEDUCTIONS FOR NON-BUSINESS INTEREST©

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I. An Overview

A. Section 469(a) defers the "passive activity loss" ("PALL") and "passive activity credit*" in the case of specific taxpayers.

B. Obvious major issues raised by this rule are:

(1) To which taxpayers does section 469 apply?

(2) What is a PAL?

(3) Under what circumstance does a deferred PAL become allowable, and under what circumstances does the deferred PAL disappear or get added to the basis of some property?

(4) How do the rules of section 469 interrelate with other deferral or disallowance rules such as the "at risk" provisions and investment interest limitations?

II. Taxpayers Subject to PAL Rule

A. Individuals, Estates and Trusts [sec. 469(a)(1)(A)] and Personal Service Corporation [sec. 469(a)(1)(C) and 469(j)(2)].

Personal service corporations are those described in section 269A(b)(1) with modifications, *viz*., corporations whose principal activity is the performance of personal services where such services are substantially performed by owner-employees. A person is an owner-employee if such person owns *any* stock actually or constructively under section 318, with complete pass-through to shareholders of stock held by corporations. The definition of a personal service corporation, for purposes of the PAL rule, does not include a corporation

* This outline doe not discuss the passive activity credit.

where the employee-owners together own less than 10% by value of a corporation's stock [sec. 469(j)(2)]. Conf. Rep., p. 139.[*] Query: Are services "substantially performed" by owner-employees only where such service constitute more than 50% of services performed? For example, would incorporated law firms meet the test if "partners," (i.e., shareholders) bill 25% of hours billed and 40% of time value of hours billed?

B. Closely Held C Corporations Described in Section 465(a)(1)(B) [secs. 469(a)(2)(B)and 469(j)(1)]

These are C corporations meeting the personal holding company stock ownership rules of section 542(a) as to direct and indirect ownership of more than 50% of the stock by five or fewer individuals (including as individuals certain tax-exempt organizations). Note, however, that special more favorable PAL rules apply to closely held C corporations that to individuals and personal service corporations, viz: PAL can be offset against non-portfolio income [sec. 469(e)(2)]; and material participation in an activity can be derived from employee activity as well as shareholder activity [sec. 469(h)(4)(B)]. If a corporation ceases to be closely held or ceases to be a personal service corporation, it can continue to deduct unabsorbed PALs in the same manner as if status did not change [sec. 469(f)(2)]. Conf. Rep., pp. 139 and 140.

C. Affiliated Corporations. In the case of affiliated corporations filing consolidated returns, it is intended that the PAL rules applicable to closely held corporations and personal service corporations be applied on a consolidated basis. Conf. Rep., p. 140.

III. Definition and Computations of PALs

A. Aggregate v. Segmented Computation. Computation of the aggregate PAL for a tax year is relevant in all tax activities may be relevant, e.g., as in the case of disposition of an activity with a deferred

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* House of Representatives Conference Report to accompany H.R. 3838, September 18, 1986, Vol. II is herein cited "Conf. Rep." and pages are designated without prefixed roman numerals, viz. page II-139 of that report is cited "Conf. Rep., p. 139."

attributable PAL; division of PALs among activities is on a pro-rata basis. Senate Finance Committee Report on H.R. 3838 dated May 29, 1986 (“SFCR”), p. 722.

B. Treatment of Prior Years’ PAL. At the end of any tax year, if the taxpayer has an unabsorbed PAL, then the year or years in which the PAL or its elements becomes a current PAL [sec. 469(b)] which will either be added to a current PAL [sec. 469(d)(1)], reduced by absorption through current year’s income [sec. 469(d)(1)], left unaffected, or, as to particular segments of the aggregate PAL, eliminated in connection with a disposition of taxpayer’s entire interest in the activity [sec. 469(g)].

C. Definition of PAL. PAL is defined as the amount by which the aggregate losses from all passive activities (having losses) exceed the aggregate income from passive activities (having income) [sec. 469(d)(1)]. All deductions “that are from passive activities” are taken into account, including those allowed under sections 162, 163, 164 and 165. Conf. Rep., p. 139. This computation includes the prior years’ unabsorbed PAL. NB – It is always desirable for a taxpayer to have an item of income or gain placed in the passive activity basket, and to have an item of loss or deduction excluded from the passive activity basket. Thus, as discussed below, there are prophylactic rules designed to protect the revenue from “misclassification” of income items or income producing activities as “passive.”

D. Definition of Passive Activities. The term passive activity means (1) any activity which involves the conduct of a trade or business in which taxpayer does not materially participate [sec. 469(c)(1)], (2) any rental activity [sec. 469(c)(2)], and (3) to the extent provided by regulation, an activity in “connection with” a trade or business or any activity with respect to which Section 212 deductions are allowable [sec. 469(c)(6)].

For purposes of section 469(c)(1)(A), a trade or business includes activities generating deductions allowable under section 174 as R & D expenditures [sec. 469(c)(5)]. Regulatory authority is meant to cause the PAL rules to apply to activities that give rise to passive losses intended to be limited under the PAL provisions but that may not rise to the level of a trade or business. [Conf. Rep., p. 138]

In determining income or loss for purposes of calculating the taxpayer's PAL, "portfolio income or loss," as described below, is eliminated [sec. 469(e)(1)]. See Exhibit A attached for diagrammatic representation.

E. Exceptions for $25,000 Real Estate Losses and Working Interest in Oil and Gas Properties.

(1) Real Estate [sec. 469(i)]. If an individual "actively participates" in rental real estate activities, up to $25,000 of the individual's PAL in any year attributable to such activities is not disallowed. The exemption phases out after tax payer's income exceeds $100,000. Taxpayer and spouse must own at least a 10% interest in real estate and cannot hold the interest through a limited partnership. Note that in a year in which rental real estate has income, this income has favorable status as passive activity income. In the case of this $25,000 allowance for passive losses from rental real estate, such losses, if not offset against other income in a particular year, may be carried forward as part of a net operating loss. SFCR, p. 722.

In applying the $25,000 real estate allowance for active participation, income and loss from all of a taxpayer's real estate activities are first netted [Conf. Rep., p. 141].

Example: Assume a taxpayer has $25,000 of losses from a real estate activity in which he actively participates, and $25,000 of gain from another real estate activity in which he also actively participates resulting in no net loss from real estate activities. Assume further the taxpayer has net losses of $20,000 from other passive activities for the year. On these facts, the real estate gains and losses would be netted, and the taxpayer would have a $20,000 PAL from the other passive activities.

If the taxpayer who does not actively participate in a real estate activity in year one has a PAL in the year, and then begins to actively participate in year two, the PAL from year one remains a PAL. Real estate losses greater than $25,000 arising in a year where taxpayer actively participates are carried over and allowable under $25,000 rule in a subsequent year if the taxpayer actively participates in the activity in a subsequent year. Conf. Rep., p. 141.

Where a taxpayer who dies actively participated in a real estate activity, his estate is deemed actively participating for two year following the death of the taxpayer so the estate can receive the same tax treatment with respect to the real estate activity as the taxpayer with respect to the real estate activity as the taxpayer did in the taxable year of his death [sec. 469(i)(4)]. Conf. Rep., pp. 141 and 142.

Trusts do not qualify for the allowance of up to $25,000 in losses from rental real estate, so taxpayers cannot circumvent the $25,000 ceiling or multiply the $25,000 allowance by transferring various rental real estate properties to one or more trusts. Conf. Rep., p. 142.

(2) Working Interests in Oil and Gas property [sec. 469(c)(3)]. Income and loss from any working interest in any oil or gas property which taxpayer holds directly or through an entity which does not limit the liability of taxpayer with regard to such interest is eliminated in calculation of PAL. If any working interest produces losses treated as non-passive, then any subsequent income from that property, or from any property where basis is determined by reference to such property, is treated as non-passive, thus precluding placing such income in the passive basket.

F. Rules for Calculating PALs and Interrelationship with Investment Interest Limitations. Rules for allocating deductions to components taken into account in calculating passive income are provided in sections 469(e)(I)(A)(II) and (III) and 469(k)(4).

(1) Personal Service Income. Section 469(e)(3) provides that earned income within the meaning of section 911(d)(2)(A) is not taken into

account in computing income or loss from a passive activity. “The [Senate Finance] committee intends that a share of partnership income, or a guaranteed payment to a partner (including a limited partner) attributable to the performance of personal services is not to be treated as passive.” SFCR, p. 720. Conf. Rep., p. 139, clarifies that income received by an individual from performance of personal services with respect to a passive activity is not treated as income from this activity so that a limited partner who is paid for performing services for the partnership (whether by way of salary, guaranteed payment, or allocation of partnership income) cannot shelter such income by passive losses from the partnership or any other passive activity.

(2) Reflections on Imputed Personal Service Income. The concept of imputing income for uncompensated personal services to one member of a group engaged in economic activities and thereby diminishing the taxable income of the other members is familiar. See e.g. section 1366(e) (in an S corporation, compensation can be imputed to persons providing uncompensated services) and section 704(e) (similar rule for family partnerships). It appears that the same type of analysis could be made under section 469 if an individual did not make a proper charge for services. The Senate Committee and Conference Reports cited in Paragraph F(1) above refer to a partner in a partnership, but the principle would presumably be applicable to the shareholders of an S corporation or to a sole proprietorship.

> Example (1): Assume an individual self-manages rental property he own and provides management and repair services of a type which would have been recognized under section 163(d)(5)(B)(ii) of the Senate Bill (the value of certain imputed compensation considered expended for purposes of determining whether a net lease exists). [This provision does not appear in the Conference Bill.]

If the taxable income of the property without regard to imputed personal service income is $1,000 and the fair market value of the imputed services is $1,500, does the individual have a PAL of $500? Suppose the personal services were in the nature of imputed income from leasing commissions for a two-year lease. Would the PAL be $750 in the first year on the basis that only half the imputed leasing commission would be "deductible" in the first year?

Example (2): Suppose an individual manages his own investment portfolio on a fulltime basis. Assume the gross income of the portfolio is $10,000 and the fair market value of the uncompensated services is $1,000. Query whether the individual is taxable on $1,000 of compensation income and has a $1,000 deduction under section 212 subject to the 2% deduction floor.

(3) Interest Expense. Interest deductions attributable to passive activities are not treated as investment interest [sec. 163(d)(3)(B)(ii)]. Thus, these deductions are subject to limitation under the PAL rules and not under investment interest limitations. Income and loss from passive activities generally are not treated as investment income or loss in calculating the amount of the investment limitation [sec. 163(d)(4)(D)], but passive loss allowed by reason of the phase-in of the PAL provision (other than losses from rental activities in which the taxpayer actively participates) reduces net investment income. [Conf. Rep., p. 139.] Interest on a debt secured by taxpayer's residence is not taken into account even if borrowed funds are invested in a passive activity [sec. 469(j)(7) and SFCR, p. 720].

Query: If a partnership engaged in a rental real estate activity borrows money by mortgaging a profitable building and invests the funds in marketable securities, is the interest deduction on such borrowing attributable to the investment in the marketable securities, hence treated as investment interest deductible against investment and portfolio income, or is the interest deduction treated as arising from the passive rental activity, hence not deductible against portfolio income? What if the borrowing took place many years ago? How would use of funds be traced? The Conf. Rep., p. 146, states that Treasury regulations covering the area of interest allocation are to be promulgated by December 31, 1986 [sec. 469(k)(4)].

(4) Stacking of Losses. In determining the interrelationship between NOLs and suspended PALs, note that NOL carryovers, like current year losses other than PALs, are allowed against any income of the taxpayer. In the case of individuals, estates and trusts, and personal services corporations, however, such non-passive losses and NOLs are taken into account only after reducing income from passive activities by current and suspended deductions from passive activities (but not below zero). Thus the application of any prior year's suspended PALs against current year's passive income is taken into account before such NOLs are applied against net passive income, thus permitting the taxpayer to obtain the full benefit of suspended PALs which are limited in application before using any current losses that are not from passive activities or NOL carryovers. If the taxpayer has net passive activity income after application of all suspended PALs, income may be offset by current year non-passive losses and by NOL carryovers. SFCR, pp. 722 and 723.

IV. Material Participation Defined

A. Requirement of Regularity, Continuity, and Substantiality. Section 469(h)(1) provides that a taxpayer shall be treated as materially participating in an activity only if the taxpayer is involved in the operations of the activity on a regular, continuous and substantial basis. This rule applies to individuals and, in the case of trusts and estates, the test is based on whether the fiduciary, as such, meets the meets the material participation standard, and in grantor trusts whether the grantor meets this standard. SFCR, p. 735. "Regardless of whether an individual directly own an interest in a trade or business activity (e.g., as a proprietorship), or owns an interest in an activity conducted at the entity level by a passthrough entity such as a general partnership or S corporation, he must be involved in the operations of the activity on a regular, continuous, and substantial basis, in order to be materially participating." SFCR, p. 720. The Senate Finance Committee Report states that a taxpayer must materially participate in an activity throughout the taxable year. SFCR, p. 730.

The Senate Finance Committee Report provides the following additional guidance (page 732): The material participation standard is based upon sections 1402(a), relating to self-employment tax, and 2032A, relating to valuation of farm property, but it is modified in accordance with the purposes of the passive loss provisions. However, applications of these preexisting legal standards are not intended to be controlling. Periodic consultation with respect to general management decisions will not create active participation. An individual's involvement must relate to operations to constitute material participation. Material participation is most likely to occur in cases where an activity is taxpayer's principal business. See further generally SFCR, pp. 732-5.

The Conference Agreement endorses the meaning of "material participation" as set forth in the Senate Finance Committee Report. The Conf. Rep. clarifies that an individual who works full time in a line of business consisting of one or more business activities generally is likely to be materially participating in these activities (except to the extent provided otherwise in the case of rental activities) even if the individual's role is in management rather than operations. This clarification is not intended to alter the description of material participation in the Senate Finance Committee Report in any respect. The Conf. Rep. also clarifies that a taxpayer is likely to be materially participating in an activity if he does everything that is required to be done of conduct the activity, even though the actual amount of work to be done to conduct the activity is low in comparison with other activities. Conf. Rep., pp. 147 and 148.

B. Application to C Corporations [sec. 469(h)(4)]. In the case of all corporations subject to the PAL rules, the taxpayer is treated as materially participating in an activity if one or more shareholders holding stock representing more than 50% (by value) of the outstanding stock of the corporation materially participate in the activity. In the case of closely held corporations, but not personal service corporations, a second test of material participation looks to services furnished by non-shareholder employees.

C. Limited partnership [sec. 469(h)(2)]. In the case of limited partnerships, the holder of a limited partner's interest is treated as being engaged in a passive activity, irrespective of his actual participation as a limited partner or general partner. Where the taxpayer owns a limited partnership through a tiered arrangement, such as an S corporation or a general partnership, he is still deemed not to be actively participating in the business of the limited partnership. Where a taxpayer owns both a limited partnership interest and a general partnership interest with respect to the same activity, lack of material participation is conclusively presumed with respect to the limited partnership interest, even if the limited partner taxpayer may materially participate with respect to his general partnership interest. SFCR p. 731. However, where a limited partnership holds portfolio securities, income and gain from such securities are not considered passive income. SFCR, p. 729.

D. Participation by Spouse. In determining whether a taxpayer materially participates (or actively participates), the participation of the spouse of the taxpayer is taken into account [sec. 469(h)(5)].

E. Regulatory Authority and Anti-Abuse Rules. The Secretary is granted specific authority to prescribe regulations which specify what constitutes material participation for purposes of section 469 [sec. 469(k)]. The Senate Finance Committee Report, p. 730, states: "The Secretary may prescribe regulations under which items of income from a limited partnership or other passive activity are treated as portfolio income." The Senate Finance Committee Report states an intention that such regulation will prevent "taxpayers from structuring income-producing activities (including those that do not bear significant expenses) in ways that are designed to produce passive income that may be offset by unrelated passive losses. For example, such regulations may provide that, where necessary to prevent avoidance of the passive loss rule, a limited partner's share of income from a limited partnership is treated as portfolio income. Circumstances in which such treatment could be appropriate would include a transfer by a corporation of an income-producing activity to a limited partnership with a distribution to shareholders of limited partnership interests." SFCR, p. 730. See also, SFCR, p. 731.

The Conference Report states that in connection with the Treasury Regulations regarding definition of income that is treated as portfolio income or as otherwise not arising from a passive activity, Conferees intend that the regulatory authority be exercised to protect the underlying purpose of the passive loss provisions which is preventing the sheltering of positive income sources through the use of tax losses derived from passive business activities. Conf. Rep., p. 147, states:

> "Examples where the exercise of such authority may (if the Secretary so determines) be appropriate include the following: (1) ground rents that produce income without significant expense; (2) related party leases or sub-leases with respect to property used in a business activity, that have the effect of reducing active business income and creating passive income; and (3) activities previously generating active business losses that taxpayer intentionally seeks to treat as passive at a time when they generate net income with the purpose of circumventing the rule."

V. Rental Activity and Portfolio Income Defined.

A. Rental Activity [sec. 469(j)(8)]. The following guidance is provided in the Senate Finance Committee Report at pages 741 and 742: Rental activity, which is specifically included as a part of passive activities, does not include any activity where payments are not principally for the use of tangible property. Hotel operations and short-term auto leasing are not rental income because personal services are involved. Old Sub S section 1372(e)(5) furnishes a useful analogy. Rental activity does not include payments for use of intangibles like stock or other payments more properly characterized as interest. The Conf. Rep., p. 148, notes that provision of washing machines in a laundry room of a rental apartment building would be part of rental activity.

B. Straining out Rental Income and Deductions. In what many will view as a Draconian approach, the Senate Finance Committee Report describes rules which would make it very difficult to offset losses from rental of property against which could be viewed as integrally related. Thus the Senate Finance Committee Report provides as follows (p. 743):

> "Some businesses involve the conduct of rental activities in association with other activities not involving renting tangible property. Although the other activities may immediately precede the rental activity, be conducted by the same persons, or take place in the same general location, they are not treated as a part of the rental activity, because under the passive loss rule rental activities are considered passive activities without regard to the taxpayer's material participation. In the case of other activities, an examination of the taxpayer's material participation generally determines whether an activity as passive. Rental activities generally are treated as separate from nonrental activities involving the same persons or property. Thus, for example, automobiles leasing is treated as a different activity from automobile manufacturing, and real estate construction and development is a different activity from renting the newly constructed building.
>
> "Similarly, suppose a travel agency operated in the form of a general partnership has its offices on three floors of a ten-story building that it owns. The remainder of the space in the building is rented out to tenants. The travel agency expects to take over another floor for its own use in a year. The partnership is treated as being engaged in two separate activities: a travel agency activity and a rental real estate activity. Deductions and credits attributable to the building are allocable to the travel agency activity only to the extent that they relate to the space

occupied by the travel agency during the taxable year." SFCR, p. 743

Consider here the possibility of imputing personal service income discussed in III-F(2) p. 6, <u>supra</u>.

C. <u>Portfolio Income</u> [sec. 469(e)(1)(A)]. A fundamental exclusion from passive income is portfolio income defined as follows:

"In determining the income or loss from any activity ––

"(A) IN GENERAL. – There shall not be taken into account -– (i) any (I) gross income from interest, dividends, annuities, or royalties not derived in the ordinary course of a trade or business, (II) expenses (other than interest) which are clearly and directly allocable to such gross income, and (III) interest expense properly allocable to such gross income; and (ii) gain or loss attributable to the disposition of property (I) producing income of a type described in clause (i), or (II) held for investment. For purposes of clause (ii), any interest in a passive activity shall not be treated as property held for investment."

Expenses and interest allocable to portfolio income are not deemed attributable to a passive activity. Treasury is to issue regulations for allocation of expenses and interest to portfolio income by December 31, 1986. Conf. Rep., p. 146.

Section 469(e)(1)(B) states that "any income, gain, or loss which is attributable to an investment of working capital shall not be treated as arising in the ordinary course of a trade or business." See example at SFCR, p. 730.

<u>Example (1)</u>: Assume a limited partnership is actively engaged in trading stocks, bonds and other securities for gains and for dividend and interest income. The partnership is not, however, a dealer in any of the items. Presumably the expenses of management are either section 212 expenses or section 162 expenses. In either case, how are the deductions

of expenses treated? Can they create PALs or are they subject to the 2% section 212 floor?

Example (2): A limited partnership engaged in business (rental real estate or otherwise) has held some vacant land which it sells at a gain. If the land has been "held for investment," the gain is portfolio income. There is no statutory restriction of the type of property which can be deemed "held for investment."

The Senate Finance Committee Report provides the following guidance (pp. 728 and 729): Dividends on C corporation stock, REIT and RIC dividends, interest on debt obligations and royalties from the licensing of property are generally included in portfolio income. Income from a general or limited partnership interest, from S corporation stock, from a grantor trust, or from the lease of property generally is not treated as portfolio income. Such interests can generate losses which may be applied to shelter unrelated income of the taxpayer. In addition, although such interests might otherwise be considered as held for investment, gains on the sale of such interests, when they are interests in passive activities, are not treated as portfolio income [sec. 469(e)(1)(A)] except to the extent gain on sale of such interests is itself attributable to portfolio income. For example, if stocks a general partnership owns a portfolio of appreciated stocks and bonds and also conducts a business activity, a part of the gain on sale of the partnership interest would be attributable to portfolio income and would, consequently, be treated as portfolio income. SFCR, pp. 728 and 729. Conf. Rep., p. 146, confirms that REIT and RIC dividends, as well as income received through real estate mortgage investment conduits, are to be treated as portfolio income.

D. Exception for Pass-Through Interest. Where an individual receives interest income on debt of a passthrough entity in which he owns an interest, a problem of characterization is involved.

Example: Assume an individual taxpayer own 100% of the stock of an S corporation and makes a loan to the S corporation. Assume further the taxpayer receives $100 of interest on this loan. Absent a special rule, the interest paid by the S corporation would add to its passive losses, and the shareholder would have $100 of portfolio income not subject to offset by passive losses.

The Conference Agreement provides that, to the extent the taxpayer receives interest income with respect to a loan to a pass-through entity in which he has an ownership interest, the income should be allowed to offset the interest expense passed through to the taxpayer from the activity in the same taxable year. Conferees anticipate appropriate Treasury regulations will be provided [sec. 469(k)(4)]. Conf. Rep., pp. 146 and 147.

VI. Scope of an Activity

A. If two undertakings are part of the same activity, taxpayer need only establish material participation with respect to the activity itself as a whole, whereas, if there are separate activities, he must establish such participation separately for each. In the case of disposition, the scope of activity is critical in determining whether taxpayer has disposed of his entire interest in the activity or only a portion thereof. Thus, broadening the scope of activities would be helpful in proving material participation and narrowing or segmenting the scope would be helpful in allowing losses on dispositions. SFCR, pp. 738 and 739. On the other hand, if an activity produces income, the absence of material participation could be of benefit to the taxpayer in producing passive income.

B. The fact that two undertaking are conducted by the same entity, such as a partnership or S corporation, does not establish they are part of the same activity and, conversely, the fact that two undertakings are conducted by different entities does not establish they are different activities. SFCR, p. 740

VII. Disposition of Interest in Passive Activity; or Interest Becoming Non-Passive

A. Disposition on Death. The unabsorbed PAL of an individual taxpayer, if not previously absorbed or eliminated, will terminate on the death of a taxpayer in accordance with the following rule: The amount of the PAL is first compared with the gain which would be recognized if the activity had been transferred in a taxable transaction, which gain would presumably be reflected in the step-up in basis on death. The balance, if any, of the PAL is allowed as an ordinary deduction in the last taxable year of the decedent. See SFCR, p. 726. Note this test is on an activity-by-activity basis [sec. 469(g)(2)].

> Example: Taxpayer dies holding two activities to which unabsorbed PALs of $100 apiece would be attributed. If both activities were sold in taxable transactions, the first passive activity would produce a gain of $150, and the second passive activity would produce a gain of $70. In these circumstances it appears that $30 of the PAL attributed to the second activity is allowed as a deduction to the decedent.

B. Disposition of 100% of Interest in Taxable Transactions.

(1) Stacking of Losses. In general, if a taxpayer disposes of 100% of his interest in a passive activity, any net loss, taking into account prior unabsorbed PALs and any gain or loss on the disposition transaction, is offset first against any net income or gain from other passive activities for the year, and second against any other income or gain [sec. 469(g)(1)].

> Example: Assume taxpayer is engaged in passive activities A, B and C. Activity A has an unabsorbed PAL of $100. Passive activities B and C have no unabsorbed PAL. During the taxable year, 100% of Activity A is sold at a gain of $30; activity B has PALs during the year of $50; and activity C has passive income during the year of $50. The $30 gain on activity A is offset first against the $100 of unabsorbed PAL from activity A, leaving $70 of PAL from activity A to be allowed. Query whether the $50 of passive income from activity B is offset against the remaining $70 of loss first, so that only $20 of the loss can offset against other

income, leaving taxpayer with a PAL from activity C of $50 or, in contrast, whether the $50 of gain from Activity B is offset by $50 of loss from Activity C, leaving taxpayer with no PAL and a deduction against other income of $70.

(2) Multiple Activities and Multiple Entities. The Senate Finance committee Report provides the following guidance at pp. 725 and 726 as supplemented by, Conf. Rep., p. 145: A disposition of the taxpayer's entire interest involves a disposition of the taxpayer's interest in all entities that are engaged in the activity, and to the extent held in proprietorship form, of all assets used or created in the activity. If a general partnership or S corporation conducts two separate activities, a fully taxable disposition by the entity of all the assets used to create one activity constitutes a disposition of the partner's or shareholder's interest in the activity. Similarly, if a grantor trust conducts two separate activities, the grantor is considered as disposing of his entire interest in that activity.

(3) Sham Transactions, Wash Sales, Etc. The Conference Agreement contemplates that transactions constituting a sale or other taxable disposition in form but which are not treated as a taxable disposition under general tax rules do not give rise to the allowance of suspended deductions. For example, sham transactions, wash sales and transfers not properly treated as sales due to the existence of a put, call, or similar right relating to repurchase do not give rise to the allowance of suspended losses. Conf. Rep., p. 143.

(4) Related Party Dispositions. Under the conference Agreement, a taxpayer is not treated as having disposed of an interest in a passive activity for purposes of triggering suspended losses if he disposes of it in an otherwise fully taxable transaction to a related party within the meaning of section 267(b) or 707(b)(1) including applicable attribution rules. In the event of such a related party transaction, which is not treated as a disposition, suspended losses are not triggered but rather remain with the taxpayer. Note that the suspended losses do not increase the basis of a

property in the hands of the transferee. The suspended losses may be offset by income from other passive activities of the taxpayer in the future. Where the related party ultimately makes a transfer in a fully taxable disposition of the activity on which the original loss was not allowed, the taxpayer can deduct the suspended losses attributable to his interest in the passive activity [sec. 469(g)(1)(B)]. Conf. Rep., p. 143. Query: If a related party dies, do suspended losses become allowable as if the transferor died?

(5) Insurance Syndicates. When the owner of an interest in any insurance syndicate insuring U.S. risks disposes of his interest in the syndicate in a fully taxable closing transaction, he is treated as having made a disposition of his interest in the passive activity. Conf. Rep., p. 143.

(6) Dispositions by Abandonment. The scope of a disposition triggering suspended losses under the PAL rules includes an abandonment, constituting a fully taxable event under present law, of the taxpayer’s entire interest in the passive activity. For example, if taxpayer owns rental real property which he abandons in a taxable event, which would give rise to a deduction under section 165(a) of present law, abandonment constitutes a taxable disposition that triggers recognition of suspended losses under the PAL rule. Similarly, if the event of the worthlessness of a security is treated under section 165(g) as a sale or exchange of security, and the event of the worthlessness otherwise represents the disposition of an entire interest in a passive activity, it is treated as a disposition. Conf. Rep., p. 144.

(7) Interaction with Capital Loss Transactions. Upon the fully taxable disposition of a taxpayer’s entire interest in a passive activity, any loss on disposition which is capital loss remains subject to limitations on deduction of capital losses [sec. 469(g)(1)(C)]. Conf. Rep., p. 144.

C. Disposition on Installment Sales. If a passive activity is disposed of at a gain on an installment sale, then any unabsorbed PALs from the activity are allowed in the year the installment obligation is collected in the same proportion that the gain recognized on the installment obligation during such year bears to the total gain to be recognized on the installment obligation [sec. 469(g)(3)].

D. Disposition by Gift. On disposition of any interest in a passive activity by gift, the basis of the transferred interest is increased by the amount of PALs allocable to the transferred interest and the PALs so allocable are not allowable as a deduction for any taxable year [sec. 469(j)(6)]. Note that basis to transferee for purposes of determining loss cannot exceed fair market value. SFCR, p. 726.

E. Passive Activity Becoming Active. If a passive activity ceases to be passive, any unabsorbed PALs from such activity survive and are subject to offset by income of such activity or entity in subsequent years in accordance with the rules set out in section 469(f)(1). A closely held corporation which becomes widely held cannot offset PALs against portfolio income under section 469(f)(2), with the same rule applicable to personal service corporations changing status. Conf. Rep., pp. 139 and 140.

F. Tax-Free Exchanges. For rules where there is a tax-free exchange of a passive activity under section 351, 721 or 1031, see SFCR, page 727. Apparently, a suspended PAL is ultimately allowable on the taxable disposition of acquired property. The discussion in the Senate Finance Committee Report as to allowance of unabsorbed PALs only against income from the same activity in different form would appear to be applicable only if the successor activity were not a passive activity, because if it were a passive activity, any net income would be subject to offset by any PAL.

Gain recognized on the transfer of a partial interest in the passive activity, and gain (boot) on a tax-free transfer of an entire or partial interest, are treated as passive income subject to offset by losses and credits from passive activities. However, such transfers are not treated as dispositions triggering all suspended losses from the activity [SFCR, p. 719 footnote]. Query as to what the result is when a C corporation or a personal service corporation liquidates with an unabsorbed PAL. What happens on the termination of a trust or estate? Is it possible that on a liquidation of a corporation, if all gain or loss is recognized after the repeal of General Utilities, that the unabsorbed PALs would be recognized? What is the result if there is an asset transfer? What happens to unabsorbed PALs in the case of corporate reorganizations where assets of PAL operation move to another corporation. Is section 381 applicable?

VIII. Limitations on Deductions for Non-Business Interest

A. Key Statutory Terms in Defining Investment Interest.

(1) Property held for investment [sec. 163(d)(5)]

(2) Investment interest [sec. 163(d)(3)(A)]

(3) Investment income [sec. 163(d)(4)(B)]

(4) Investment expense [sec. 163(d)(4)(C)]

(5) Net investment income [sec. 163(d)(4)(A)]

B. Property Held for Investment.

(See Exhibit B) "Property held for investment" is an integral part of the definition of "investment interest" [sec. 163(d)(3)(A)] and "investment income" [sec. 163(d)(4)(B)]. The words "property held for investment" are not defined further in the statute except by specific inclusion of:

(1) Property producing portfolio income under section 469(e)(1) [which definition is partially circular because section 469(e)(1) itself includes property held for investment] [sec. 163(d)(5)(A)(i)]; and

(2) An interest held by taxpayer which meets the statutory definition of a passive activity

under section 469(c)(1) but which is nevertheless not a passive activity presumably because under regulation promulgated pursuant to section 469(k) the activity (and its related positive income) was pushed out of the passive activity basket [sec. 163(d)(5)(A)(ii)].

C. Investment Interest and Personal Interest. (See Exhibit C)

(1) The definition of investment interest includes interest paid or accrued on indebtedness incurred or continued to purchase or carry property held for investment. Investment interest includes interest expense property allocable to portfolio income under the PAL rule [sec. 163(d)(3)(A)]. Conf. Rep., p. 153.

(2) The Conf. Rep. states that investment interest also includes interest expense properly allocable to an activity, involving a trade or business in which the taxpayer does not materially participate, if that activity is not treated as a passive activity under the PAL rules [sec. 163(d)(3)(B)(ii)]. This presumably covers instances where “anti-abuse” regulations convert income from passive to active income or portfolio income [sec. 469(k)]. Investment interest also includes the portion of interest expense incurred or continued to purchase or carry an interest in a passive activity to the extent attributable to portfolio income [sec. 163(d)(3)(A)]. Conf. Rep., p. 153.

(3) Investment interest does not include any interest that is taken into account in determining taxpayer’s income or loss from a passive activity [sec. 163(d)(3)(B)(ii)]. The Conf. Rep. states investment interest does not include interest properly allocable to rental real estate activity in which the taxpayer actively participates within the meaning of the passive loss rules, presumably here referring to the $25,000 exemption [sec. 469(i)]. Conf. Rep., p. 153.

(4) The investment interest limitation is not intended to disallow a deduction for interest expense which in the same year is required to be

capitalized or is otherwise specially treated, for example, construction interest subject to section 263(a) or interest disallowed under section 265 relating to tax-exempt interest. Conf. Rep., p. 154.

(5) Personal interest generally includes interest on tax deficiencies but does not include qualified residence interest or interest payable on estate tax deferred under section 6163 or section 6166 [sec. 163(h)(2)]. Conf. Rep., p. 154.

Detailed provisions for calculating qualified residence interest with applicable transition rules are set out in Conf. Rep., pp. 154-6 [sec. 163(h)(3)].

D. Investment Income. (See Exhibit D)

(1) Investment income includes gross income from property held for investment, gain attributable to disposition of property held for investment and amounts treated as gross portfolio income under the passive loss rules. [sec. 163(d)(4)(B) and sec. 469(e)(1)(A)]. Investment income also includes income from interest and activities, involving a trade or business, in which the taxpayer does not materially participate, if that activity is not treated as a passive activity under the passive loss rules [sec. 469(k)(3)]. Presumably, this covers cases in which the "anti-abuse" regulations push trade or business activities in which taxpayer does not materially participate out of the passive activity basket because they have income. Conf. Rep., p. 153.

(2) Net investment income is investment income net of investment expenses [sec. 163(d)(4)(A)]. Investment expenses are deductible expenses, other than interest, directly connected with the production of investment income [sec. 163(d)(4)(C)]. In determining deductible investment expenses, it is intended that investment expenses be considered as those allowed after application of the rule limiting deductions for miscellaneous expenses to those expenses exceeding 2% of AGI. In computing the amount of expenses that exceed the 2% floor, expenses that are not investment expenses are

intended to be disallowed before any investment expenses are disallowed. Conf. Rep., pp. 153 and 154.

IX. Phase-in; Transition Rules; Application to Minimum Tax

For regular tax phase-in rules, see Conf. Rep., pp. 148 and 149, and pp. 156 and 157 (interest limitation rules). Phase-ins are not applicable to alternative minimum tax. Conf. Rep., p. 258 (passive loss rules) and p. 259 (investment interest rules).

X. Examples and Queries as to the Application of PAL and Non-Business Interest Rules to Trading in Commodities, Options and Securities.

Example (1): Assume an individual floor trader on a commodity exchange or option exchange has a net capital gain from the activity for the taxable year.

Q(1). Could this gain be sheltered by real estate losses?

A(1). No. The gain is either portfolio income or active business income.

Query (A) How would the gain be treated for purposes of the investment interest limitation? If the activity is a trade or business, then income is not investment income and cannot support deduction of other unrelated investment interest.

Query (B) How would the related expenses of the trader be treated?

Example (2): Suppose an individual floor trader on a commodity exchange or option exchange has a net trading loss from the activity for the taxable year.

Q(1). Could the trading loss offset unrelated dividend and interest income?

A(1). No, the loss remains a capital loss in any event, and deduction of capital losses against ordinary income of any type remains restricted.

Q(2). Could this trading loss offset the individual's other unrelated capital gain?

A(2). Yes. The loss could not be a PAL, because, even if the capital loss were a trade or business loss, the individual materially participated.

Example (3). Suppose there is a limited partnership trading in commodity futures or stock options. The limited partnership has net trading income.

Query (A) How is the distributive share of this income characterized for limited partners with respect to the investment interest limitation and the PAL rules?

Query (B) What is the tax treatment to the limited partners for their distributive share of management fees and other expenses?

Query (C) How, if at all, would the answers to Queries (A) and (B) change if the limited partnership had a net trading loss for the year?

Query (D) What would be the tax treatment of the general partner in the circumstances outlined in Queries (A), (B) and (C)?

Donald Schapiro
9/24/86

QUESTIONS

FACTS: Assume that each of the following entities is actively trading futures and options:

A. Individual speculator

B. Floor trader

C. Limited partner in a partnership, which in addition to trading futures and options, also is a dealer in government securities

D. General partner in partnership described in C above

QUESTIONS:

1. Are expenses of the futures and options activity deductible under section 163 or 212?

2. Are the futures and options property “held for investment” for purposes of the investment interest limitations and the portfolio income exclusions of the PAL rules?

3. How is interest incurred to carry the futures and options activity treated?

4. Is income and loss from the futures and options activity investment income and loss?

5. Does the futures and options activity generate portfolio income or loss for the PAL rules?

6. Are losses from futures and options activity PALs?

PLEASE COMPLETE AND RETURN ON THE BASIS THAT UPPRT JALF OF EACH BOX ASSUMES QUESTION 2 IS ANSWERED “HELD FOR INVESMENT” AND LOWER HALF OF EACH BOX ASSUMES QUESTION 2 IS ANSWERED “NOT HELD FOR INVESTMENT”

TAXPAYER

Question	A	B	C	D
1	§12			
2	Assume held for investment	Assume held for investment	Assume held for investment	Assume held for investment
	Not held for investment	Not held for investment	Not held for investment	Not held for investment
3	Investment Interest			
4	Yes			
5	yes if PAL rules applicable			
6	No			

Exhibit A

Exhibit B

Exhibit C

Exhibit D

NEW YORK STATE BAR ASSOCIATION

Tax Reform Act of 1986 (the "Act")
Conference Agreement
Miscellaneous Itemized Deductions
Interest Limitations

October 9, 1986

I. Miscellaneous Itemized Deductions

A. Under current law, the following employee business expenses are deductible above the line in arriving at adjusted gross income:

(1) certain expenses reimbursed by the employer;

(2) expenses for travel away from home;

(3) transportation expenses; and

(4) expenses of outside salesmen.

In addition, moving expenses of an employee or self-employed individual are an above-the-line deduction.

B. Under Act Section 132

(1) employee business expenses (other than reimbursed expenses) are allowed only as itemized deductions and are subject to the 2% floor described below;

(2) a new above-the-line deduction is added for certain expenses paid or incurred by a qualified performing artist in connection with the performance of services in the performing arts as an employee; a "qualified performing artist" is an individual who (a)

performed services during the taxable year for at least two employers, (b) whose employee deductions exceed 10% of gross income and (c) whose adjusted gross income for the taxable year does not exceed $16,000;

(3) moving expenses of an employee or self-employed individual are allowed only as an itemized deduction and are <u>not</u> subject to the 2% floor; and

(4) miscellaneous itemized deductions are allowed only to the extent that the aggregate amount of such deductions exceeds 2% of adjusted gross income; “miscellaneous itemized deductions” means itemized deductions other than

(a) interest;

(b) taxes;

(c) Section 165 casualty losses and gambling losses to the extent of gambling winnings;

(d) charitable contributions;

(e) medical expenses (the new floor is 7½% of adjusted gross income);

(f) moving expenses;

(g) impairment-related work expenses;

(h) the Section 691(c) deduction for estate tax in the case of income in respect of a decedent;

(i) any deduction allowable in connection with personal property used in a short sale;

(j) the Section 1341 deduction relating to the computation of tax when a taxpayer restores a substantial amount held under a claim of right;

(k) the Section 72 (b)(3) deduction where annuity payments cease before the investment is recovered;

(l) the Section 171 deduction for amortizable bond premium; and

(m) the Section 216 deduction in connection with cooperative housing corporations;

the miscellaneous itemized deductions that are subject to the 2% floor include

(i) unreimbursed employee business expenses (including union and professional dues) and home office expenses of an employee;

(ii) Section 212 deductions related to investment income or property (such as investment counsel fees);

(iii) Section 212(3) deductions for tax return preparation costs and similar expenses; and

(iv) the Section 183 hobby loss deduction for expenses up to the amount of income from the activity.

II. Interest Limitations

A. The Act limits the deductibility of three types of interest:

(1) interest that is taken into account in determining the taxpayer's income or loss from a passive activity (not covered in this outline);

(2) investment interest; and

(3) personal interest.

B. Act Section 511(a) amends Code Section 163(d) to provide that, in the case of a taxpayer other than a corporation, the amount allowed as a deduction for investment interest for a taxable year shall not exceed the net investment income of the taxpayer for the taxable year.

(1) Disallowed investment interest can be carried forward.

(2) "Investment interest" is any interest on indebtedness incurred or continued to purchase or carry property held for investment. Investment interest does not include (a) any "qualified residence interest" (see below) or (b) any interest that is taken into account under new Section 469 in computing income or loss from a passive activity.

(3) "Net investment income" is the excess of investment income over investment expenses. Investment income and investment expenses do not include any income or expenses taken into account under Section 469 in computing income or loss from a passive activity. Investment income is gross income and net gain from property held for investment.

(4) Investment income is reduced by the passive activity loss that is allowed during the phase-in of

the passive loss limitation (except for the portion of such loss that is attributable to a rental real estate activity with respect to which the taxpayer actively participates).

(5) “Property held for investment” includes (a) any property that produces income of a type described in Section 469(e)(1) (interest, dividends, annuities and royalties not derived in the ordinary course of a trade or business, gain or loss from property producing such income and property held for investment (other than an interest in a passive activity)) and (b) any interest in an activity involving the conduct of a trade or business (i) which is not a passive activity and (ii) with respect to which the taxpayer does not materially participate.

(6) For 1987-1990, the amount of investment interest disallowed is equal to the sum of

(a) the applicable percentage (35% for 1987, 60% for 1988, 80% for 1989 and 90% for 1990) of the amount otherwise disallowed to the extent such amount does not exceed the ceiling amount (zero for a trust, $5,000 for a married individual filing a separate return and $10,000 for other taxpayers);

(b) the amount otherwise disallowed in excess of the ceiling amount; and

(c) carryforwards.

The amounts in (a) and (b) are computed without regard to the amount in (c). For example, if a taxpayer has $20,000 of investment interest expense in excess of investment income in 1987, 35% of the amount that does not exceed $10,000, that is, $3,500, plus the amount in excess of $10,000 is disallowed. Assuming there is no net passive loss, $6,500 is allowed and $13,500 is disallowed. N.B. House Congressional Resolution 395 changes the rule contained in this paragraph (6) to provide that interest disallowed during 1987-1990 shall not exceed the sum of (i) the amount that would be disallowed if (x) investment interest could be deducted up to the sum of the ceiling amount and net investment income and (y) investment income were not reduced by allowed passive losses during the phase-in and the material participation provision set forth in new Section 163(d)(5)(A)(ii)(II) did not apply and (ii) the applicable percentage of the excess of the amount which would otherwise be disallowed over the amount in (i).

C. Act Section 511(b) provides a new Code Section 163(h), which states that, in the case of a taxpayer other than a corporation, no deduction shall be allowed for personal interest paid or accrued during the taxable year.

(1) "Personal interest" is any interest other than (a) interest incurred in connection with the conduct of a trade or business (other than the trade or business of performing services as an employee),

(b) investment interest, (c) any interest taken into account in computing income or loss from a passive activity, (d) qualified residence interest, and (e) certain interest payable on deferred estate tax.

(2) “Qualified residence interest” is interest on indebtedness secured by a qualified residence of the taxpayer. “Qualified residence” means the taxpayer’s principal residence plus one other residence selected by the taxpayer. Qualified residence interest does not include interest allocable to the portion of the principal of the indebtedness that, when added to the outstanding aggregate principal amount of all other indebtedness previously incurred and secured by the residence, exceeds the lesser of

(a) the fair market value of the qualified residence, and

(b) the sum of (i) the taxpayer’s basis in the qualified residence adjusted by the cost of improvements (but the amount in this clause (b) shall not be less than the outstanding principal amount (as of August 16, 1986) of indebtedness incurred on or before August 16, 1986, and secured by the qualified residence on August 16, 1986) and (ii) the aggregate amount of indebtedness secured by a qualified residence and incurred after August 16, 1986, to pay for qualified medical expenses or qualified educational expenses.

According to the Conference Report, the taxpayer’s basis for purposes of (b)(i) above is determined without taking into account adjustments under Section 1034(e) (rollover of gain) or Section 1033(b) (involuntary conversions) or adjustments for depreciation.

(3) Indebtedness secured by coop stock is treated as secured by the house or apartment that the taxpayer is entitled to occupy. If coop stock may not be used to secure indebtedness, indebtedness is treated as so secured if the taxpayer establishes that the indebtedness was incurred to acquire the stock.

(4) The personal interest disallowance is phased in at the rate of 35% for 1987, 60% for 1988, 80% for 1989 and 90% for 1990.

Patricia Geoghegan

LAW AND BUSINESS

TAX REFORM CONFERENCE
SEPTEMBER 25, 1986

ALTERNATIVE MINIMUX TAX

John S. Nolan

I. Overview of Minimum Tax Issues.

A. The existence of any minimum tax provision is to some extent a recognition of the shortcomings of the tax system itself.

B. To the extent the tax system accurately measures and taxes the economic income of the taxpayers, there is no need for a minimum tax.

C. Our tax system, however, has been and obviously will continue to be used as a tool for implementing economic and social policies. It accomplishes these goals by providing incentives or disincentives or particular types of activities.

D. Tax preferences that are provided as incentives can have the effect of enabling some taxpayers with substantial economic incomes to pay little or no tax. The ability of wealthy taxpayers to avoid paying virtually any taxes through the use of tax preferences has long been perceived as a problem of our tax system.

E. In providing for a minimum tax, the tax system recognizes that, although tax preferences provide incentives for worthy goals, they become counterproductive when taxpayers can use them to avoid virtually all tax liability. The goal of a minimum tax is to ensure that no taxpayer with substantial economic income can avoid significant tax liability through the use of tax preferences.

II. Legislative History.

A. The first minimum tax was enacted as part of the Tax Reform Act of 1969. It provided for a tax rate of 10 percent, which applied to both corporations and individuals. The tax base was the amount which certain tax preferences exceeded an exemption of $30,000 plus the taxpayer’s regular income tax. Since the minimum tax was payable in addition to the taxpayer’s regular income tax, the minimum tax enacted in 1969 is generally referred to as an add-on minimum tax.

B. Realizing the shortcomings of the minimum tax provision enacted in 1969, Congress in 1976 increased the tax rate and reduced the exemption amount for both the corporate and individual minimum tax. The tax rate was increased to 15 percent for both corporations and individuals, while the exemption amount for individuals was reduced to the greater of $10,000 or one-half of the regular taxes paid. For corporations, the exemption amount was reduced to the greater of $10,000 or the full amount of regular taxes paid.

C. The first alternative minimum tax appeared in the Revenue Act of 1978. It applied to individuals and was payable only if it exceeded their regular tax. The tax base for this tax was generally the taxpayer's taxable income plus certain itemized deductions plus the capital gains deduction. The tax rate was graduated with a maximum rate of 25 percent for income over $100,000.

D. The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) repealed the add-on minimum tax for individuals and adopted the present alternative minimum tax.

III. Present Law.

A. Corporate Minimum Tax.

1. Unlike individuals, corporations still pay an add-on minimum tax on certain tax preferences. The current corporate minimum tax is codified at Section 56 of the Internal Revenue Code (Code). It provides for a minimum tax of 15 percent on a Corporation's tax preferences to the extent that the aggregate amount of these preferences exceeds the greater of the regular income tax paid or $10,000 (Code § 56(a)).

2. Tax Preferences.

a. Accelerated depreciation on real property. -- With respect to section 1250 property, the amount by which the deduction allowable for the taxable year for exhaustion, wear and tear, obsolescence, or amortization exceeds the depreciation deduction which would have been allowable for the taxable year had the taxpayer depreciated the property under the straight-line method for each taxable year of its useful life. In the case of property eligible for ACRS, this time period is presently nineteen years (Code § 57(a)(2)).

b. Amortization of certified pollution control facilities. -- With respect to a certified pollution control facility which is being amortized over a period of 60 months pursuant to an election under section 169 of the Code, the amount by which the deduction allowable for the taxable year exceeds the depreciation deduction that would otherwise be allowable (Code § 57(a)(4)).

c. Reserve for losses on bad debts of financial institutions. -- In the case of certain financial institutions, the excess of the bad debt deductions allowable over the amount of those deductions computed on the basis of actual experience (Code § 57(a)(7)).

d. Depletion. -- The excess of the percentage depreciation allowable under Section 611 of the Code for the taxable year over the adjusted basis of the property at the end of the taxable year (Code § 57(a)(8)).

e. Capital gains. -- 18/46 of a corporation's net capital gain (Code § 57(A)(9)(b)).

f. Additional tax preferences for personal holding companies. -- In addition to the listed tax preferences, accelerated depreciation on leased personal property, mining, exploration and development costs, circulation expenditures, research and experimental expenditures, and excess intangible drilling costs also give rise to preferences in the case of personal holding companies (Code §§ 57(a)(1), (3), (5), (6), (11), and (12)(a)).

3. Deferral of minimum tax liability in the case of certain net operating losses. -- When a corporation has a regular tax net operating loss attributable to minimum tax preference items in excess of $10,000, no immediate add-on minimum tax liability is incurred with respect to those preference items. Instead, minimum tax liability is incurred when the preference portion of the net operating loss is used to offset regular taxable income in the succeeding taxable year or years. The preferential portion

of the net operating losses treated as used only after nonpreferential net operating losses have been totally exhausted (Code § 56(b)).

4. Cut back in certain preferences.

   a. In 1982 Congress enacted section 291 of the Code which imposed a cutback in the use of certain corporate tax preferences for regular tax purposes. This section operates in conjunction with the add-on minimum tax for corporations under present law. Adjustments are made to the corporate minimum tax to prevent the combination that tax and the cutback provision from unduly reducing the tax benefit from a preference.

   b. Items to which the cutback applies.

      i. Depletion for coal and iron ore. –- The excess of percentage depletion otherwise allowable for iron ore and coal over the adjusted basis of the property is reduced by 15 percent (Code § 291 (a)(2)). To coordinate this cutback with the minimum tax provisions, only 71.6 percent of such excess is treated as a corporate tax preference item under the minimum tax (Code § 57(a)(8) and § 57(b)).

      ii. Bad debt reserves. -- The bad debt reserve deduction is reduced by 20 percent of the amount by which the otherwise allowable deduction exceeds the amount which would have been allowable on the basis of actual experience (Code § 291(a)(3)). This cutback is coordinated with the minimum tax provisions by considering only 59 5/6 percent of such amount as a tax preference item under the minimum tax (Code § 57(a)(7) and § 57(b)).

iii. Tax-exempt interest. -- In the case of a financial institution, 20 percent of the otherwise allowable interest deduction allocable to debt incurred or continued to purchase tax-exempt obligations acquired after 1982 is disallowed (Code § 291(a)(3)).

iv. Foreign sales corporations. -- A foreign sales corporation’s exempt foreign trade income is reduced by approximately 1/16th where there is a corporate shareholder (Code § 29l(a)(4)).

v. Section 1250 property. -- The amount treated under the recapture rules as ordinary income on the sale or other disposition of section 1250 property by a corporation is increased by 20 percent of the additional amount which would have been treated as ordinary income if the property were subject to recapture under section 1245 of the Code (Code § 291(a)(1)). The minimum tax preference for the remaining 80 percent of the capital gain that would have been ordinary income under section 1245 is reduced by 40 1/6 percent (Code § 57(a)(9)(b) and 57(b)).

vi. Pollution control facilities. -– Twenty percent of the basis of pollution control facilities to which an election under section 169 of the Code applies is treated as if the election did not apply (Code § 29l(a)(5)). The minimum tax preference for the remaining property for which five-year amortization was elected is reduced by 40 1/6 percent (Code § 57(a)(4) and 57(b)).

vii. Intangible drilling costs. -- In the case of an integrated oil company, 20 percent of the amount otherwise allowable as a deduction for intangible drilling cost under section 263(c) of the Code is capitalized to the oil, gas, or geothermal property and deducted ratably over a 36-month period beginning with the month the costs are paid or incurred (Code § 291(b)).

Viii. Mineral exploration and development cost. -- Twenty percent of the amounts otherwise allowable as deductions under sections 616 and 617 of the Code are capitalized and treated as if they are used to acquire recovery property assigned to the five-year class. ACRS deductions are allowed beginning with the year the expenses are paid or incurred, and the investment tax credit is available in the year the expenses are paid or incurred (Code § 291(b)).

B. Individual Minimum Tax.

1. Individuals are presently subject to an alternative minimum tax which is payable in addition to all other tax liabilities to the extent that it exceeds the individual's regular tax owed. The tax is imposed at a flat rate of 20 percent on alternative minimum taxable income in excess of the exemption amount (Code § 55(a)). However, the amount so determined is reduced by the foreign tax credit and refundable credits (Code § 55(c)).

2. Alternative minimum taxable income is computed by adding to regular adjusted gross income certain tax preferences and decreasing such amount by the alternative tax itemized deductions. The exemption amount is then subtracted from alternative minimum taxable income before applying the 20-percent rate. Under present law, the exemption amount is $40,000 for joint returns, $20,000 for married individuals filing separately, and $30,000 for single returns (Code § 55(f)).

3. Tax Preferences.

   a. Exclusion for dividends. – Dividends excluded from gross income under Section 116 of the Code, which permits individuals to exclude dividends received in an amount not to exceed $100 on a-single return or $200 on a joint return (Code § 57(a)(1)).

   b. Accelerated depreciation on real property. -- The excess of accelerated over straight-line depreciation applying the useful life or recovery period prescribed for regular tax purposes (Code § 57(a)(2)).

   c. Accelerated depreciation on leased personal property. -- The excess of accelerated depreciation over depreciation calculated under the straight-line method using useful lives or recovery periods of five years for three-year property, eight years for five year property, 15 years for 10-year property, and 22 years for 15-year public utility property (Code § 57(a)(3)).

d. Amortization of certified pollution control facilities. -- The excess of 60-month amortization over the amount of depreciation otherwise allowable (Code § 57(a)(4)).

e. Mining, exploration and development cost. -- The excess of the amount claimed as an expense over that allowable if the cost had been capitalized and amortized ratably over a ten-year period (Code § 57(a)(5)).

f. Circulation expenditures relating to newspapers, magazines and other periodicals. -- The excess of the amount deducted under section 173 of the Code over that allowable if the amounts have been capitalized and amortized ratably over a three-year period (Code § 57(a)(6)).

g. Research and experimental expenditures. -- The excess of the deduction claimed under section 174 of the Code over that allowed if the amounts had been capitalized and amortized ratably over a 10-year period (Code § 57(a)(6)).

h. Depletion. -- Percentage depletion to the extent in excess of the adjusted basis of the property (Code § 57(a)(8)).

i. Capital gains. -- The portion of net capital gains deducted from gross income under section 1202 of the Code (Code § 57(a)(9)(A)).

j. Incentive stock options. -- The excess of the fair market value received through the exercise of an option over the exercise price (Code § 57(a)(10)).

k. Intangible drilling costs. -- The amount by which the excess of the deduction claimed over that allowable if the cost had been capitalized and amortized ratably over a 10-year period exceeds the amount of net oil and gas income (Code § 57(a)(11)).

4. For certain preferences, individuals can elect for regular tax purposes to take a

deduction ratably over 10 years and thereby avoid having such items treated as tax preferences (Code § 58(i)). The preferences with respect to which such an election can be made are research and experimental expenditures, intangible drilling and development costs, and mining exploration and development costs. An election is also available for a ratable deduction of circulation expenditures over a period of three years. In addition, the ACRS provisions themselves allow certain similar elections (Code § 168(f)(2)(c)).

5. Alternative minimum tax itemized deductions.

   a. Casualty or theft losses and gambling losses to the extent not in excess of gambling gains (Code § 55(e)(1)(A)).

   b. Charitable deductions to the extent allowable for regular tax purpose (Code § 55(e)(1)(B)).

   c. Medical deductions to the extent in excess of 10 percent of adjusted gross income (Code § 55(e)(1)(C)).

   d. Qualified interest expenses. -- Qualified housing interest plus other interest expenses deducted by the taxpayer, but only to the extent not in excess of qualified net investment income for the year (Code § 55(e)(1)(D)).

e. Deductions for estate tax attributable to income in respect to a decedent under section 691(c) of the Code (Code § 55(e)(1)(E)). All other regular tax itemized deductions are not allowed for minimum tax purposes.

6. Credits and Net Operating Losses.

a. In calculating minimum tax liability, no nonrefundable credits are allowed except for the foreign tax credit (Code § 55(c)). Limitations similar to those in effect for regular tax purposes apply for minimum tax purposes as well, but are recalculated to reflect the percentage of minimum taxable income that comes from foreign sources (Code § 55(c)(2)(C)).

b. Credits that do not benefit the taxpayer because of the imposition of the minimum tax liability can be carried back and forth through other taxable years (Code § 55(c)(3)). Individuals with net operating losses are allowed to deduct such losses against alternative minimum taxable income. However, for years beginning after 1982, the losses are computed for minimum tax purposes by reducing the regular tax net operating losses by the amount of the items of tax preference (Code § 55(d)(2)).

IV. 1986 Tax Reform Act.

A. Overview.

In enacting the Tax Reform Act of 1986, Congress decided that the minimum taxes under present law did not adequately address the problem of tax avoidance principally for two reasons. First, Congress felt that the corporate minimum tax, as an add-on rather than an alternative tax, was not designed to define a comprehensive income base. Second, Congress believed that the present minimum tax bases for individuals and corporations failed to sufficiently approach the measurement of economic income. Directed by these problems, Congress enacted an alternative minimum tax for both corporations and individuals, which is applied on a much broader base than present law.

B. Structure.

1. Corporations. -- An alternative minimum tax, similar to the present individual minimum tax, replaces the add-on tax under present law. The tax base for this new tax is the taxpayer’s regular taxable income, increased by the

taxpayer's tax preferences for the year, and adjusted by computing certain deductions in a special manner intended to negate the acceleration of such deductions under the regular tax. The resulting amount, which is designated as "alternative minimum taxable income," is then reduced by the appropriate exemption amount.

2. Individuals. -- The structure for the alternative minimum tax on individuals generally is the same as under present law, except that adjustments are made to insure that basis will be fully recovered under both the regular tax and minimum tax systems.

C. Tax Rate.

The minimum tax rate for individuals will be increased to 21 percent, while the rate for corporate taxpayers is set at 20 percent (proposed Code § 55(b)).

D. Exemption Amount.

The exemption amounts for individuals under present law are generally retained, however, they are reduced by 25 percent of the amount by which a taxpayer's alternative minimum taxable income exceeds $150,000. ($112,500 for singles and $75,000 for marrieds filing separately). A similar phased-out exemption is provided for corporate taxpayers (proposed Code § 55(d)). Thus, an individual or corporate taxpayer with alternative minimum taxable income in excess of $310,000 would receive no alternative minimum tax exemption.

E. Tax Preferences -- Corporations.

The new alternative minimum tax for corporations generally retains the corporate preferences under present law and adds several new ones. The amount of each corporate tax preference is measured after the application of section 291 of the Code (proposed Code § 59(f)).

1. Depreciation. -- Accelerated depreciation on real and personal property placed in service after 1986 will be treated as a tax preference to the extent the depreciation allowed exceeds the depreciation calculated under the new alternative depreciation system (proposed Code § 56(a)(1)).

   a. Under this system, the cost of property other than (1) section 1250 property and (2) property with respect to which the taxpayer elects or is required to use the straight-line method for regular tax purposes, is recovered using the 150-percent declining balance method, switching to the straight-line method, generally over the ADR midpoint life (proposed Code $ 56(a)(1)(A)(ii)).

   b. The preference does not apply to property that is expensed under section 179 of the Code.

C. Rather than simply designating the amount of accelerated depreciation with respect to specific items as a tax preference item, the alternative depreciation deduction is substituted for the ACRS deduction. Thus, to the extent an alternative deduction relating to an item of property exceeds the ACRS deduction for that year, the amount of the preference is reduced.

2. Use of the completed contract method. -– For contracts entered into after March 1, 1986, the percentage of completion method is substituted for the completed contract method in determining minimum taxable income relating to that contract (proposed Code $ 56(a)(3)).

3. Intangible drilling costs. -- The present law preference for intangible drilling costs for individuals and personal holding companies is extended to apply to all corporations with an offset of 65 percent of net oil and gas income (proposed Code $ 57(a)(2)).

4. Installment sales of certain property. -– For minimum tax purposes, a taxpayer generally is required to recognize all gain with respect to the disposition of dealer property after March 1, 1986, in the year in which the disposition takes place (proposed Code § 56(a)(6)).

5. Capital construction funds of shipping companies. -- Amounts deposited in a capital construction fund established under section 607 of the Merchant Marine Act of 1936 are not deductible in determining alternative minimum taxable income. Similarly, earnings of such a fund are not excludable in computing alternative minimum taxable income (proposed Code § 56(c)(2)).

6. Tax-Exempt Interest. -- Interest on private activity bonds (other than qualified section 501(c)(3) bonds issued on or after August 8, 1986, that continue to be exempt for regular tax purposes) is treated as a preference. Certain refundings of pre-1986 bonds, however, are not treated as a preference (proposed Code § 57(a)(5)).

7. Charitable contributions of appreciated property. -- In the case of a charitable contribution of appreciated property, amount of the untaxed appreciation allowed as a regular tax deduction under section 170 of the Code is treated as an item of tax preference. The preference does not apply to carryovers of the deduction with respect to charitable contributions made before August 16, 1986 (proposed Code § 57(a)(6)).

8. Special deduction for certain tax-exempt insurance providers. -- The special deduction

allowed for certain existing Blue Cross/Blue Shield organizations and for new organizations meeting certain requirements with respect high risk coverages is a minimum tax preference (proposed Code § 56(c)(3)).

9. Business Untaxed Reported Profits.

a. Overview.

i. Surely the most controversial and revolutionary change in the Tax Reform Act of 1986 is the inclusion as a tax preference of 50 percent of the excess of a corporation's pre-tax book or financial statement income (with certain adjustments for taxes and special rules for related corporations) over other alternative minimum taxable income, (proposed Code § 56(f)). Presumably in response to the publicity surrounding incidents of many large corporations reporting substantial book income while paying little or no tax, this provision applies for taxable years 1987 through 1989.

ii. For taxable years beginning after December 31, 1989, pre-tax book income is replaced for this purpose by adjusted current earnings (essentially earnings and profits, with certain adjustments), and the relative percentage is increased to 75 percent (proposed Code § 56(g)). Under this provision, which is outlined for the first time in the conference report, when alternative minimum taxable income exceeds adjusted current earnings, it would be reduced by 75 percent of the difference. These rules apply whether adjusted current earnings or alternative minimum taxable income are positive or negative numbers. A positive amount is always treated as exceeding a negative amount, and a smaller negative amount is treated as exceeding a larger negative amount.

b. Applicable financial statement income.

i. The taxpayer’s applicable financial statement is the statement it provides for regulatory or credit purposes, for the purpose of reporting to shareholders, or for other substantial nontax purposes. If a corporation has more than one type of statement, highest priority is given to financial statements filed with the Securities and Exchange Commission (SEC). Second in priority are audited financial statements that are certified and used for credit purposes, for reporting to shareholders or other owners, or for any other substantial nontax purpose. Third in priority are financial statements required to be provided to the Federal Government or its agencies (other than the SEC), a state government or its agencies, or a political subdivision or its agencies. In the absence of any such statements, any financial statement or report that is used for credit purposes, for reporting to shareholders or other owners, or for any other substantial nontax purposes is considered the applicable financial statement. Within a category of priority, statements prepared for credit purposes have the highest priority, with statements prepared for shareholder reporting purposes having priority over any statement prepared for other substantial nontax purposes (proposed Code § 56(f)(3)).

ii. If a taxpayer does not have any of the enumerated financial statements, but maintains books and records, it may summarize such records for use as a financial statement. In the case of a taxpayer with no books and records capable of summarization, its net income or loss for financial statement purposes shall be deemed equal to its earnings and profits for the taxable year. Similarly taxpayers who do not file statements with the SEC or a government agency and who do not obtain certified audited statements may elect to equate financial statement net income with their earnings and profits for the taxable year (proposed Code § 56(f)(3)(B)).

c. Adjustments to financial statement income.

i. Taxes. -- Financial statement income and expense items relating to federal income taxes and those foreign income taxes eligible for the foreign tax credit must be removed (proposed Code § 56(f)(2)(B)).

ii. Consolidated groups. -– Financial statement income must be adjusted to include all companies represented in the consolidated return. If a taxpayer receives an actual or deemed distribution from a corporation not included in its consolidated return, the amount of the distribution is included as an item of book net income. However, if the other corporation is consolidated or its ownership otherwise included for financial statement purposes, an adjustment to reverse the inclusion is necessary (proposed Code § 56(f)(2)(C)).

iii. Accounting periods. -- If a taxpayer uses different accounting periods for book and tax purposes, an adjustment must be made to conform those years by including a pro rata portion of each financial statement accounting year that includes a taxable year. If the applicable financial statement for an accounting year is not available when the taxpayer's tax return is amended when the statement is available (proposed Code § 56(f)(2)(D)).

iv. Dividends from section 936 corporations. -- Dividends received from a section 936 corporation and included in the recipient's book income must be grossed up for the amount of withholding taxes paid with respect to such dividends. To the extent the inclusion of such dividends and the related gross-up increases the alternative minimum taxable income of the recipient, the related withholding taxes are treated, for minimum tax purposes, as creditable foreign taxes paid by the recipient (proposed Code § 56(f)(2)(F)).

v. Other adjustments. -- The Secretary is empowered to prescribe by regulation other circumstances in which adjustments are necessary to prevent the omission or duplication of any item (proposed Code § 56(f)(2)(H)).

d. Differences in book and tax income.

i. Realized gains and losses deferred for tax purposes.

(a) Cancellation of indebtedness. -- Gains and losses as a result of debt extinguishment are included in income currently for book purposes, but for tax purposes may be deferred by making an election under section 108 of the Code.

(b) Taxes assessed against local benefits. -- Taxes assessed against local benefits that increase the value of the property assessed are currently deductible for book purposes, but must be capitalized as part of the basis of the property for tax purposes.

(c) Involuntary conversions. -- Gains or losses from involuntary conversions are included in income currently for book purposes, but may be deferred for tax purposes under section 1033 of the Code if the proceeds are reinvested in similar property.

(d) Gains and losses on trade-ins. -- Gains and losses on trade-ins are included in income currently for bock purposes, but are included in the basis of the new asset for tax purposes.

(e) Impairment of long-lived assets. – Losses from impairment are recognized for book purposes when the impairment is considered permanent, but are recognized only through depreciation or disposal for tax purposes.

ii. Intangible assets with indeterminable lives.

(a) Organizational expenditures. -- Organizational expenditures are deductible currently for book purposes, but may only be amortized over a period of not less than 60 months for tax.

(b) Trademark expenditures. -- Trademark expenditures are generally capitalized and amortized for book purposes, but are capitalized and not amortized for tax.

(c) Goodwill. -- Goodwill is capitalized and amortized over a period not to exceed 40 years for book purposes, but is a nonamortizable capital asset for tax.

iii. Recognition of loss contingencies.

(a) Estimated cost of guarantees and warranties. -- (Estimates of such costs may be deducted at the date of sale for book purposes, but may only be deducted for tax when paid.

(b) Estimated cost of settling pending lawsuits. -- Such costs are deductible when the loss becomes probable for book purposes, but are only deductible for tax purposes when paid.

(c) Uninsured losses. -- Uninsured losses may be deducted for book purposes when the loss becomes probable, but are only deductible for tax purposes when paid.

(d) Estimated losses on inventory. Such losses are deductible for book purposes when the loss becomes probable, but are only deductible for tax purposes when realized through sale or disposal except as permitted by the cost or market, whichever is lower, tax convention as limited by Thor Power Tool Co. v. Commissioner, 439 U.S. 522 (1979).

(e) Estimated losses on the disposal of facilities and discontinuing or relocating operations. -- Such losses are deductible for book purposes when the loss becomes probable, but are only deductible for tax purposes when realized through sale or disposition.

iv. Advance receipts.

(a) Fees, dues, service contracts, rents, and royalties. -- Included in income as received for tax, but deferred until earned for book purposes.

(b) Sale and leasebacks. -- Gains are included in income on the date of sale for tax purposes, but are generally deferred and amortized over the lease term for book purposes.

v. Other differences.

(a) Tax-exempt interest. -- Tax-exempt interest is recorded on the financial statement, but is permanently excluded from the federal income tax base. Thus, taxpayers holding large portfolios of tax-exempt obligations will be subjected to a substantial tax increase under the revised minimum tax rules

(b) Rental payments. -- Rental payments are recognized on a level basis for book purposes, but are recognized when received for tax.

(c) Dividends received. -- Eighty percent of dividends received are excluded from taxable income. For book purposes, however, dividends received from investments carried on the cost basis are included in income, while dividends received from investments carried on the equity method reduce the basis of the investment.

(d) Depreciation methods and lives. -- For tax purposes, the cost of assets acquired prior to 1987 and used in a trade or business may be recovered under ACRS, with $10,000 a year subject to expensing under section 179 of the Code (phased out for every dollar of qualifying investment in excess of $200,000). For assets acquired in 1986 and subsequent years, the new partially accelerated tax depreciation system in this tax bill will apply. For book purposes, however, the cost of assets is recovered under straight line or various other methods over take useful lives of the properties. Because of the different methods and lives used for depreciation, subsequent gains and losses on dispositions of depreciable property will also differ.

(e) Pension costs. -- Pension costs are deductible based on contributions, with limitations, for tax. For book purposes, however, pension costs are deductible based on the accrual method of accounting and are unaffected by funding.

e. Effect of the book income preference.

The book income preference will undoubtedly raise a large portion of the revenue that Congress expects to gain from enacting the new alternative minimum tax for corporations. Revenue will be generated by taking advantage of timing differences between financial statement reporting and reporting for tax purposes and by taxing income items that are booked for financial statement purposes but excluded from the tax base. The preference will also provide an advantage for nonpublic companies, which will have more flexibility in planning for the minimum tax since their financial statements need not be certified audited statements filed with the SEC.

F. Tax preferences. -- Individuals.

1. Retained preferences. -- The Tax Reform Act of 1986 retains the current individual tax preferences for 60-month amortization on certified pollution control facilities (the provision is

repealed for regular tax purposes, effective in 1986), expensing of mining exploration and development costs, expensing of circulation expenditures, expensing of research and experimental expenditures, and percentage depletion.

2. New or altered preferences applying to both corporations and individuals. -– The corporate tax preferences mentioned earlier with respect to accelerated depreciation on real and personal property, charitable contributions of appreciated property, tax-exempt interest, use of the completed contract method, and use of the installment method of accounting are also applicable to individual taxpayers.

3. Intangible drilling costs. -- The tax preference for intangible drilling costs is retained; however, the 100 percent of net oil and gas income threshold amount for treatment as a tax preference is reduced to 65 percent of such amount (proposed Code § 57(a)(2)).

4. Incentive stock options. -- The tax preference for incentive stock options is generally the same as under present law; however, for minimum tax purposes, the basis of stock acquired through the exercise of an incentive stock option after 1986 equals the fair market value taken into account in determining the amount of the preference (proposed Code § 57(a)(3)).

5. Net losses from passive trade or business activities. -- The excess net loss with respect to trade or business activities in which the taxpayer did not materially participate in management or provide substantial personal services is treated as a preference. This preference amount is reduced by the amount, if any, of the taxpayer's insolvency. Unlike the similar provision for regular taxes, there is no five-year phase-in for minimum tax purposes (proposed Code § 58(b)).

6. Passive farm losses. -- Net losses from farming activities in which the taxpayer does not materially participate are treated as a tax preference. The amount of the preference is reduced by the amount, if any, of the taxpayer's insolvency (proposed Code § 58(a)). This preference also applies to personal service corporations (proposed Code § 58(a)(3)).

G. Alternative minimum tax itemized deductions -– Individuals.

The rules relating to itemized deductions under the present alternative minimum tax are generally retained. However, the definition of net investment income, which is used to determine the amount of deductible interest expenses, is conformed to the definition adopted for regular tax purposes. The five year phase-in of the extension of the limitations on deductions of non-business investment interest under Section 163(d) of the Code is not applicable for minimum tax purposes.

H. Adjustments in other years when taxpayer pays minimum tax.

When a taxpayer pays alternative minimum tax, the amount of such tax paid relating to deferral preferences (preferences other than those that result in permanent exclusion of certain income for regular tax purposes) may be carried forward indefinitely and used to offset regular tax liabilities. This minimum tax credit cannot be used to reduce minimum tax liabilities in subsequent years and cannot be carried back. In the case of an acquisition of assets of a corporation to which section 381(a) of the Code applies, any unused minimum tax credits of the acquired corporation will be treated as a “tax attribute” that is taken into account by the acquiring corporation, subject to the limitations under sections 381 through 383 of the Code (proposed Code § 53).

I. Tax Credits.

1. Incentive Tax Credits -- The rules relating to incentive tax credits are basically the same as under present law for individuals. Corporations, however, are permitted to use regular investment tax credits to offset 25 percent of their tentative minimum tax liability for the year. The amount of minimum tax that is treated as paid, for purposes of the minimum tax credit, is determined without regard

to the use of investment tax credits (proposed Code § 53(c)(4)). As under present law, credits that cannot be used for regular tax purposes due to the minimum tax can be used as credit carryovers against the regular tax.

2. Foreign Tax Credit -- Foreign tax credits cannot offset more than 90 percent of minimum tax liability as determined without regard to foreign tax credits and net operating losses (proposed Code § 59(a)). Amounts disallowed by reason of this limitation may be carried forward to other taxable years.

J. Net operating losses.

Net operating losses cannot offset more than 90 percent of alternative minimum taxable income. Again, amounts disallowed by reason of this limitation may be carried forward and used in subsequent taxable years (proposed Code § 56(d)).

K. Suspended losses.

Suspended losses under sections 465, 704(d), 1366(d) and other sections of the Code specified in regulations are to be recomputed for minimum tax purposes, to apply with respect to amounts otherwise deductible for purposes of the minimum tax. Thus, the amount of the deductions recaptured or suspended may differ for regular and minimum tax purposes (proposed Code § 59(h)).

L. Tax benefit doctrine.

Application of the tax benefit doctrine to the minimum tax is placed within the discretion of the Secretary of the Treasury (proposed Code § 59(g)).

M. Special rule with respect to estates and trusts. With respect to estates and trusts, minimum tax liability will apply by determining distributable net income on a minimum tax basis (proposed Code § 59(c)).

N. Regular Tax Elections.

Taxpayers generally can elect to have minimum tax rules measuring a particular item apply for regular tax purposes (proposed Code § 59(e)).

O. Estimated Tax Payments.

Corporations are required to make estimated tax payments with respect to minimum tax liability (proposed Code § 53(d)).

P. Effect of new minimum tax provisions.

1. The most obvious ramification of the new alternative minimum tax is that, rather than simplify, it adds on additional layer of complexity to the tax system. Corporations will now be required to maintain records and measure income in accordance with three different systems. Accounting decisions will also be elevated to a much greater level of importance.

2. Because of the expansion of tax preferences to which the tax applies and the high rates of tax in relation to the top regular tax rates, the alternative minimum tax will be a much more important component of the tax structure. Indeed, some taxpayers will probably be subject to the alternative minimum tax every taxable year. It is estimated that the new minimum tax provisions will raise a total of $35.8 billion during the fiscal years 1586-1991. $31 billion of this amount will come from corporations, while the remaining $4.8 billion will be raised from the changes made to the individual alternative minimum tax.