REPORT #568

TAX SECTION

New York State Bar Association

COMMENTS ON THE PROPOSED REGULATIONS
CONCERNING THE CORPORATE ALTERNATIVE MINIMUM TAX
BOOK INCOME ADJUSTMENT

August 26, 2013

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REPORT # 568

TAX SECTION
New York State Bar Association

August 26, 1987

Hon. Laurence B. Gibbs
Commissioner of Internal Revenue
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Dear Commissioner Gibbs:

I am enclosing a report on Comments on the Proposed Regulations Concerning the Corporate Alternative Minimum Tax Book Income Adjustment prepared by the Alternative Minimum Tax Committee of the Tax Section of the New York State Bar Association. The report was written by the Chairmen of that Committee, Eugene L. Vogel and William H. Weigel, together with David C. Humphreys and Willard S. Moore. Helpful comments were received from Arthur A. Feder, Robert J. Levinsohn, Richard O. Loengard, Jr., Donald Schapiro, Ruth Schapiro and Victor Zonana. The report was approved by the Executive Committee of the Tax Section.

The report comments on definitions of applicable financial statements and financial statement income, foreign operations and foreign taxpayers, applicability of generally accepted accounting principles, and problems of double taxation including discussion of subpart F income and book-tax accounting discrepancies.

Sincerely,

Donald Schapiro

Copies of this letter and report
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COMMENTS ON THE PROPOSED REGULATIONS CONCERNING THE CORPORATE ALTERNATIVE MINIMUM TAX BOOK INCOME ADJUSTMENT

The Alternative Minimum Tax Committee (the "Committee") of the Tax Section of the New York State Bar Association[1] has reviewed the proposed regulations concerning the corporate alternative minimum tax book income adjustment, issued by the Internal Revenue Service (the "Service"), and published in the Federal Register on April 28, 1987.

Part I of this report describes the statutory language and legislative history necessary for an understanding and evaluation of the proposed regulations, and summarizes briefly the structure of the proposed regulations. Part I1 discusses in detail the significant issues with regard to which the Committee either supports the proposed regulations, questions the proposed regulations, or believes that there are important issues that the proposed regulations fail to resolve.

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[1] This report was written by the Chairmen of the Committee, Eugene L. Vogel and William H. Weigel, together with David C. Humphreys and Willard S. Moore. Helpful comments were received from Arthur A. Feder, Robert J. Levinsohn, Richard O. Loengard, Jr., Donald Schapiro, Ruth G. Schapiro, and Victor Zonana.

I. INTRODUCTION

The Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (the “1986 Act”), imposed a new corporate alternative minimum tax (“AMT”). The most significant provision of the new corporate AMT, in terms of novelty, complexity, and anticipated revenue, is the book income adjustment. The provision was apparently designed to reduce the perceived embarrassment to the tax system that occurs when large corporations report positive earnings to the public, but pay little or no tax. The book income adjustment provisions apply to all corporations, however, regardless of their size and regardless of whether their earnings are publicly reported.

The book income adjustment, imposed by Sections 56(c) and 56(f) of the Internal Revenue Code of 1986 (the “Code”), in effect imposes a tax on a corporation's financial statement income, without regard to the corporation's income as computed under tax accounting principles.

A. Operation of the Corporate Alternative Minimum Tax

The first step in computing AMT liability is to compute AMT income, which will generally be greater than regular taxable income. In some instances, regular taxable income must be adjusted, generally by recomputing various components of regular taxable income. In other instances, certain defined “items of tax preference”

must be added to regular taxable income. I.R.C. §55(b)(2). After computing AMT income, a corporate taxpayer subtracts an exemption amount. The exemption amount is $40,000, reduced by 25 percent of the amount by which AMT income exceeds $150,000. Id. $55(d). Hence, once AMT income reaches $310,000, the exemption amount is zero. AMT income, less the exemption amount, is multiplied by 20 percent, and the product is reduced by the AMT foreign tax credit, to produce the taxpayer's “tentative minimum tax.” The excess of the tentative minimum tax over the taxpayer's regular income tax liability is the taxpayer's AMT liability. This amount must be paid in addition to the taxpayer's regular income tax liability. & §55(a), (b). Code Section 56 specifies the adjustments that must be made to regular taxable income to produce AMT income. Section 57 defines items of tax preference. Section 58, which affects primarily individuals and personal service corporations, prohibits certain “tax shelter” deductions from being used to reduce AMT income. Section 59 contains various definitions and special rules.

B. Statutory Provisions concerning the Book Income Adjustment

Among the required adjustments to regular taxable income is the book income adjustment. In order to compute the required book income adjustment, the taxpayer must first compute its “adjusted net book income.” Code Section 56(f)(2) provides that “adjusted net book income” means net income or loss as reported on the taxpayer's “applicable financial statement,” subject to certain adjustments.

Thus, the determination of a taxpayer's adjusted net book income requires a three-step process: first, determine what constitutes the taxpayer's applicable financial statement; second, determine what number represents the net income or loss reported on such statement (this number may be termed "financial statement income" or "net book income"); and third, determine what adjustments must be made to produce adjusted net book income.

The determination of a taxpayer's applicable financial statement is governed by Code Section 56(f)(3), which provides that the applicable financial statement is, in order of priority: (a) a financial statement required to be filed with the Securities and Exchange Commission (the "SEC"); (b) a certified audited financial statement used (i) for credit purposes, (ii) for reporting to shareholders, or (iii) for any other substantial nontax purpose; (c) a financial statement required to be provided to (i) the federal government or an agency thereof, (ii) a state government or an agency thereof, or (iii) a local government or an agency thereof;[2] or (d) an uncertified

[2] The technical corrections legislation recently introduced in Congress (the "Technical Corrections Bill") would amend Code Section 56(f)(3)(A)(iii) to clarify that a financial statement furnished to a governmental unit must be furnished for a "substantial nontax purpose." S. 1350, 100th Cong., 1st Sess., sec. 107(b)(8), 133 Cong. Rec. S 7926, S 7943 (1987). Thus, an income tax return cannot qualify as an applicable financial statement. In addition, the report on the Technical Corrections Bill prepared by the staff of the Joint Committee on Taxation states that an income statement used by the government only for statistical purposes cannot qualify as an applicable financial statement. Staff of Joint Comm. on Taxation, 100th Cong., 1st Sess., Description of the Technical Corrections Act of 1987 (H.R. 2636 and S. 1350) 62 (Comm. Print 1987).

financial statement used (i) for credit purposes, (ii) for reporting to shareholders, or (iii) for any other substantial nontax purpose. If the taxpayer has no applicable financial statement, its current earnings and profits (without reduction for distributions to shareholders) is considered to be its net book income. In addition, a taxpayer that has no financial statement except an uncertified statement described in clause (d), supra, may elect to use its earnings and profits as the measure of its net book income.

The Code supplies little guidance for determining what constitutes financial statement income, in cases where this issue might be debatable (i.e., where the applicable financial statement provides alternative measures of income). Apparently, Congress intended that this issue be resolved primarily by means of regulations.

Financial statement income, as reported on the taxpayer's applicable financial statement, must be adjusted in several ways in order to produce adjusted net book income. Financial statement income must be adjusted so as to disregard any item of federal income tax benefit or expense, or any item of benefit or expense attributable to foreign income taxes for which a foreign tax credit is claimed. I.R.C. §56(f)(2)(B). Several different types of adjustments may be necessary to reflect differences in the consolidation, for book and tax purposes, of affiliated corporations. Where corporations are consolidated for book but not for tax purposes, the adjusted net book income of each member of the group will be that member's share of the net book income reported on the consolidated financial statement, but adjusted in order to take into account any

intecorporate transactions eliminated in the consolidated financial statement. Thus, a parent corporation will include in its adjusted net book income the dividends received (or deemed to be received under other provisions of the Code) from a subsidiary. Similarly, where a corporation's financial statement income includes the earnings of another corporation, adjusted net book income will include only actual or deemed dividends from that other corporation. Affiliated corporations that file a consolidated tax return may on occasion issue separate financial statements. In these circumstances, the adjusted net book income of the group will equal the sum of the amounts of net book income reported on the separate financial statements, reduced by any intercorporate dividends reported on those statements. Id. §56(f)(2)(C). When a corporation uses a different year for accounting and tax purposes, its adjusted net book income will include pro rata shares of its financial statement income for the years overlapping its taxable year. Id. §56(f)(2)(D).

In addition, the Treasury Department is specifically authorized to issue regulations providing for adjustments to net book income “in order to prevent the omission or duplication of any item.” Id. §56(f)(2)(H).

To compute the book income adjustment, a taxpayer must first make all the adjustments to regular taxable income required in order to compute AMT income, except for the book income adjustment and the calculation of any allowable AMT net operating loss (“NOL”) deduction.

The resulting number may be termed “pre-adjustment AMT income.” One-half of the excess (if any) of the taxpayer's adjusted net book income over its pre-adjustment AMT income constitutes the book income adjustment and must be added to pre-adjustment AMT income. (The resulting number is then reduced by any allowable AMT NOL deduction to produce AMT income.) Id. §56(f)(1). Because the book income adjustment is defined as one-half of the excess (if any) of adjusted net book income over pre-adjustment AMT income, the book income adjustment can never be negative.

Inasmuch as the book income adjustment equals one-half of the excess of adjusted net book income over pre-adjustment AMT income, the effect of this provision, when it applies, is to impose a tax on financial statement income at a ten percent marginal rate (20 percent AMT rate times 50 percent inclusion).

C. Legislative History of the Book Income Adjustment

The book income adjustment provisions of the corporate AMT were introduced during Senate consideration of H.R. 3838, the bill that eventually became the 1986 Act. These provisions are discussed at pages 519-20 and 529-35 of the Senate Finance Committee report. S. Rep. No. 313, 99th Cong., 2d Sess. (1986).

Subsequently, the House-Senate conference committee modified the Senate version of H.R. 3838 to provide that the book income adjustment would apply only to taxable years beginning in 1987, 1988, and 1989. Commencing in 1990, the book income adjustment will be replaced by an adjustment based on “adjusted current earnings,” as defined

in Code Section 56(g). The adjusted current earnings adjustment is not covered by the proposed regulations and is not discussed in this report. With regard to 1987, 1988, and 1989, the conference committee essentially adopted the book income adjustment provisions of the Senate bill. The conference committee report added some minor clarifications to the statements contained in the Senate Finance Committee report. See 2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess., at II-272 to -274 (1986).

D. Temporary and Proposed Regulations

The Service has issued temporary regulations implementing the book income adjustment. Temp. Treas. Reg. §1.56-1T (1987). In addition, the Service has proposed that the temporary regulations be adopted as final regulations, and, accordingly, has invited comment on the temporary regulations.[3] Notice of Proposed Rulemaking, 52 Fed. Reg. 15,339 (1987).

Section 1.56-1T(a) of the proposed regulations describes the computation of the book income adjustment. Section 1.56-1T(b) deals with the determination of net book income. Section 1.56-1T(c) provides rules for determining what constitutes the taxpayer's applicable financial statement. Section 1.56-1T(d) prescribes the adjustments that must be made to net book income to produce adjusted net book income. There are also provisions in the proposed regulations

[3] Inasmuch as this report has been written in response to the Notice of Proposed Rulemaking issued by the Service, the text of this report refers to the 88proposed regulations," even though those same regulations are also currently in effect as temporary regulations.

concerning rules for special types of entities, see Prop. Treas. Reg. §1.56-1T(e), and for the payment of quarterly estimated tax, see id. §1.6655-7T (1987); these provisions are not discussed in this report.

II. COMMENTS

A. General Comments

In general, the Service has done a commendable job in identifying the numerous uncertainties created by the statutory provisions concerning the book income adjustment, and in resolving those uncertainties in a manner generally well-calculated to achieve the results intended by Congress. Nonetheless, the Committee believes that there remain some issues concerning which the proposed regulations are either silent or ambiguous. In addition, the Committee believes that in a few instances, the approach adopted by the proposed regulations appears to be unfair, and in some instances lacks support in either the Code or the legislative history.

As a general comment, the Committee wishes to note that, although the book income provisions of the 1986 Act represent a relatively novel concept, precedent on some aspects exists in the area of LIFO conformity (Code Section 472). Many of the awkward issues that have arisen in the LIFO conformity area may arise again, at a greater level of complexity, and with respect to a larger number of taxpayers, in the book income area. The Service should therefore consider, both in the drafting of regulations and in the administration of the law, some of the issues that

have arisen in the past under Section 472 and the resolution of those issues.

B. Definitions of Applicable Financial Statement and Financial Statement Income

1. Amendments and Supplements to Financial Statements

In most respects, the Committee believes that the provisions of the proposed regulations relating to priorities among multiple financial statements (where the proposed regulations do more than simply restate the provisions of the statute) are sound and commendable. The Committee is concerned, however, that some provisions of the proposed regulations relating to supplements or amendments to financial statements may be contrary to the legislative history, and, in addition, may produce unfair results in many cases.

In regard to taxpayers with multiple financial statements, sections 1.56-1T(c)(3)(i) and (ii) of the proposed regulations in essence reiterate the priorities set forth in the Code. See supra pp. 4-5. In addition, section 1.56-1T(c)(3)(iii)(B) of the proposed regulations sets forth two special rules. First, if a taxpayer has furnished two different financial statements to the SEC, one of which is a certified statement and one of which is not, the certified statement has a higher priority. Second, if a taxpayer has two uncertified statements otherwise of equal priority, one of which is accompanied by an auditor's review report and one of which is not, the statement accompanied by a review report is of higher priority. Although there is no specific support in the Code or the legislative history for these

special rules, the Committee believes that they represent a sound exercise of administrative discretion.

In situations where a taxpayer has two or more financial statements of equal priority, not covered by either of the special rules described above, section 1.56-1T(c)(3)(iii)(A) of the proposed regulations provides that the taxpayer's applicable financial statement is the statement that results in the greatest amount of adjusted net book income. The proposed regulations also apply this general rule, that a taxpayer's applicable financial statement is the statement that results in the greatest amount of adjusted net book income, to situations where a taxpayer amends its financial statement to restate its net income. Section 1.56-1T(c)(5)(iii)(B) provides that if a taxpayer restates its net book income in order to correct an error (as defined in paragraph 13 of Opinion No. 20 of the Accounting Principles Board), then the restated number represents the taxpayer's net book income. However, if the restatement of net book income is not attributable to an error (as previously defined), then the taxpayer's applicable financial statement is whichever of the original and the restated financial statements results in the greater amount of adjusted net book income.

In addition, section 1.56-1T(c)(5)(iii)(A) provides that if, after the issuance of its applicable financial statement, a taxpayer supplements or amends the statement without restating its net book income, any such supplement or amendment is considered to be part of the applicable financial statement. Thus, apparently, such supplements or amendments might result in an increase to the taxpayer's net book income, under the rules applicable to supplementary

statements set forth in section 1.56-1T(d)(5)(i), discussed below, see infra pp. 28-30.

These rules appear to conflict directly with the applicable legislative history. The Senate Finance Committee report, in discussing the effects of amendments to financial statements, states:

> In certain cases, adjustments may be made to reported financial statement income after the financial statements have been issued. It is not anticipated that such adjustments will be taken into account unless the financial statement is actually restated for the adjustments. . . .
>
> For example, a corporation obtains a certified, audited financial statement that it provides to its shareholders. Later, it is determined that the results of the corporation would be better reflected by the use of an alternative accounting method as to certain items. A second income statement reflecting the alternative accounting method is prepared. . . . If both statements [are] of equal priority, the later statement [will] be considered the applicable financial statement.

S. Rep. No. 313, supra p. 8, at 531-32.

Thus, the proposed regulations appear to be in conflict with the legislative history in several respects. Whereas the legislative history appears to contemplate that a restatement of a corporation's net book income utterly supplants a prior statement, the proposed regulations apply this rule only if the restatement is made in order to correct an error. The example in the Senate Finance Committee report, in which the taxpayer issues an amended financial statement “reflecting [an] alternative accounting method,” clearly contemplates a much broader variety of

circumstances than the mere correction of errors. In addition, the legislative history appears to indicate that later amendments or supplements to a financial statement will not be taken into account unless financial statement income is restated. The proposed regulations apply almost exactly the opposite rule. Finally, there is no support in the Code or the legislative history for the rule that in the case of conflicting financial statements of otherwise equal priority, the statement that produces the higher book income number prevails. On the contrary, the legislative history provides that, in general, the later statement governs.

Not only do the proposed regulations appear to be in conflict with the legislative history, but they may produce unfair results in many cases. A corporation might have two different financial statements of equal priority, which use different accounting methods, either because one statement is a restatement of the other, or because different users of the financial statements, such as different lenders or different government agencies, require the use of different accounting methods. For example, the two statements might use different depreciation methods. In this situation, the corporation would be, in effect, forced to use the slower depreciation method in the early years, when it produced lower depreciation expense, and would then be forced to use the more accelerated depreciation method in the later years, when the more accelerated system would be producing smaller amounts of depreciation expense. Thus, the corporation would have the worse of the two methods, and the total

depreciation expense allowed to the corporation would be insufficient fully to recover the cost of the asset being depreciated.

The Committee notes that the proposed regulations are presumably issued under the authority of Code Section 56(f)(2)(H), which authorizes the issuance of regulations providing for the adjustment of net book income “to prevent the omission or duplication of any item.” Code Section 56(f)(2)(H), however, appears to contemplate even-handed regulations, that is, regulations that prevent the duplication, as well as the omission, of any item of income, and that prevent the omission, as well as the duplication, of any item of expense. See Staff of Joint Comm. on Taxation, 100th Cong., 1st Sess., General Explanation of the Tax Reform Act of 1986 456 (Comm. Print 1987) [hereinafter General Explanation]. The rule contained in the proposed regulations, whereby the higher book income number always prevails, will frequently result in the duplication of items of income, or the omission of items of expense. In the instance of alternative depreciation methods given above, for example, there has been an omission of an item of expense, inasmuch as the taxpayer has not been permitted fully to recover the cost of the asset being depreciated. Accordingly, the Committee believes that it would be fairer, and more in accordance with the dictates of the Code, for the proposed regulations to follow the Congressional intent set forth in the legislative history, and provide that, in general, a taxpayer's latest statement is its applicable

financial statement (subject, perhaps, to restrictions -- such as prohibiting the manipulation of statement issuance dates from year to year -- to prevent obvious abuse).[4]

2. Treatment of Foreign Income and Foreign Taxpayers

Some of the most difficult questions regarding the book income adjustment involve foreign taxpayers or foreign-source income. These issues are scarcely mentioned in the legislative history. Unfortunately, the proposed regulations also fail to elucidate many of these issues. Section 1.56-1T(c)(5)(ii) of the proposed regulations, entitled "Applicable financial statement of a foreign corporation with a United States trade or business," is currently

[4] The Technical Corrections Bill would amend Code Section 56(f)(3)(C) to provide that if a taxpayer has two financial statements that have equal priority under the rules contained in the Code, the taxpayer's applicable financial statement shall be determined in accordance with regulations. See S. 1350, supra note 2, sec. 107(b)(10), 133 Cong. Rec. at S 7943. Although this legislation, if enacted, would authorize the special rules contained in section 1.56-1T(c)(3)(iii)(B) of the proposed regulations, previously discussed, see supra p. 12, the Technical Corrections Bill would not alter the fact that, in other respects, the proposed regulations fail to comport with the legislative history and with the mandate of Code Section 56(f)(2)(H).

reserved. The Committee is uncertain whether it is intended that this section, when issued, will cover United States subsidiaries of foreign corporations, or whether it will provide rules only for foreign corporations that operate in the United States directly through unincorporated branches. There are significant unresolved issues concerning both of the foregoing situations, and a delineation of more precise rules in this area is urgently needed. In addition, there are important unresolved issues regarding the tax treatment of United States corporations with foreign-source income.

(a) Foreign Corporations with United States Operations

The taxation of United States business operations conducted by foreign corporations is governed by certain fundamental principles: first, that business operations conducted by a foreign corporation should be subject to the same tax liability as would arise if those operations were conducted by a domestic corporation; and second, that income of a foreign corporation that is not received from a source within the United States, or effectively connected with a United States trade or business, should not be subject to United States taxation. Unfortunately, a workable implementation of these principles with respect to the book income adjustment may be difficult to achieve, and the

Committee understands the apparent difficulties of the Service in this area. What is needed is a concept of “effectively connected book income,” analogous to the existing concept of “effectively connected taxable income.” The Code, however, contains no such term. Indeed, the Code as it currently stands might be interpreted as taxing the worldwide book income of a foreign corporation that has any United States operations. Such an interpretation, however, would result in the violation of both long-established principles of international taxation and many tax treaties to which the United States is a party. Nowhere does the legislative history of the book income adjustment suggest that Congress intended such a radical result. Therefore, although amendment of the Code might be desirable, in order to clarify this issue, the Committee believes that the Service has the authority under present law to implement the concept of “effectively connected book income.” (This concept should govern the taxation not only of United States branches but also of foreign corporations that are members of United States partnerships.)

Similarly, Congress presumably did not intend to impose the AMT on United States source income that is not effectively connected income (e.g., dividends, portfolio interest, and capital gains), but this result needs to be made clear,

particularly for foreign corporations with United States branches.

The Committee believes that, for many foreign corporations with a United States branch, effectively connected earnings and profits is the only measure of effectively connected book income that can be computed without excessively burdening the taxpayer, and that the proposed regulations therefore should generally permit the use of effectively connected earnings and profits as the measure of a foreign corporation's effectively connected book income. The Committee notes that foreign corporations will generally be required to calculate their effectively connected earnings and profits in any event for purposes of the branch profits tax imposed by new Code Section 884.

Some foreign corporations may be able to compute effectively connected book income by reference to income as reported on a financial statement, using either of two possible approaches. The first, the “allocation approach,” would start with the taxpayer's worldwide adjusted net book income, determined under rules analogous to those applicable to United States corporations. Worldwide adjusted net book income would then be allocated, on an item-by-item basis, among the countries in which the corporation does business. As a variant of the allocation approach, in those

instances where a United States branch of a foreign corporation prepares separate financial statements, use of the income reported on those statements as the measure of the taxpayer's net book income would be relatively easy for both the Service and the taxpayer.[5] An alternative, the “apportionment approach,” would require, initially, a calculation of the taxpayer's worldwide adjusted net book income, and a calculation of its worldwide taxable income. Worldwide book income would then be multiplied by a fraction, the numerator of which would be the taxpayer's United States taxable income (the computation of which is required in any event), and the denominator of which would be the taxpayer's worldwide taxable income. The resulting number would represent the taxpayer's effectively connected book income.

Either the allocation approach or the apportionment approach might create substantial administrative burdens in particular instances. Although some foreign corporations may already generate the information necessary to employ at least one of the two approaches, or may be able to generate such information with relative ease, other corporations do not currently

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[5] The Committee believes that, under appropriate circumstances, the proposed regulations should permit the use of a “financial statement” of a branch as the applicable financial statement, even though, technically, such a statement may not qualify under the literal language of the Code as an applicable financial statement, inasmuch as the branch is not an entity for tax purposes.

generate such information and could not readily do so. For this reason, as stated previously, the Committee believes that the proposed regulations should permit the use of effectively connected earnings and profits as the measure of effectively connected book income, at least for those corporations that cannot readily comply with either the allocation approach or the apportionment approach.

(b) Foreign Corporations with United States Subsidiaries

In the case of a foreign corporation with a United States subsidiary (as opposed to a branch), the proposed regulations provide, generally, adequate guidance for the determination of the applicable financial statement and the adjusted net book income of the United States subsidiary. The proposed regulations appear to provide that, in the case of a domestic subsidiary that provides financial information only to its foreign parent (and not to creditors of the subsidiary), such information will constitute the applicable financial statement of the United States subsidiary, and the financial statements of the foreign parent will be disregarded. Section 1.56-1T(c)(5)(i)(C) of the proposed regulations states:[6]

> If any portion of the net book income of a corporation (the "first corporation") is included on the applicable financial statement of a second corporation, but the first and second corporations

[6] In the quotation from the proposed regulations, a minor typographical error has been corrected.

> are not members of the same consolidated group, the applicable financial statement of the second corporation is disregarded when determining the applicable financial statement of the first corporation. Thus, the applicable financial statement of the first corporation is the financial statement of the highest priority determined . . . without regard to the financial statement of the second corporation.

This paragraph appears to make the financial statements of a foreign parent of a United States corporation (or any other parent corporation that does not file a consolidated return with a subsidiary) irrelevant to the determination of the subsidiary's applicable financial statement or its adjusted net book income. Apparently, this result applies even if the parent's financial statement would have a higher priority than the subsidiary's (e.g., if the parent files a financial statement with the SEC, and the subsidiary does not).

Furthermore, the Committee interprets the language of the proposed regulations quoted above as meaning that a restatement by the foreign parent, in its own consolidated financial statement, of the information received from its United States subsidiary will not affect the computation of the subsidiary's adjusted net book income. For example, a foreign corporation may be required under the accounting principles of its home country to restate on a FIFO basis

financial statements computed on a LIFO basis, or to recompute depreciation on a sinking fund basis instead of the straight-line or accelerated basis permitted in the United States.

The Committee notes that the consequence, under Code Section 472, of a restatement by a foreign parent corporation of earnings reported on a LIFO basis by a United States subsidiary has been an area of considerable uncertainty. (In chronological sequence, the most significant materials relevant to this issue are: Rev. Rul. 78-246, 1978-1 C.B. 146; Insilco Corw. V. Commissioner, 73 T.C. 589 (1979), aff'd mem., 659 F.2d 1059 (2d Cir. 1981), nonacq., 1982-2 C.B. 3, nonacq. withdrawn and acq. in result substituted, 1987-25 I.R.B. 4; H.R. Rep. No. 432, 98th Cong., 2d Sess. 1380-81, reprinted in 1984 U.S. Code Cong. & Ad. News 697, 1027-29; Priv. Ltr. Rul. 8621014 (Feb. 10, 1986)). It seems clear at present, however, that such a restatement does not deprive the United States subsidiary of its ability, under Code Section 472, to report on a LIFO basis for tax purposes. As noted previously, the Committee believes that it is the intent of the proposed regulations that this same result should apply more generally in the book income adjustment area. The Committee recommends that the proposed regulations should provide (at least by means of an explicit example) that the restatement by a foreign parent

of the information provided in the applicable financial statement of a United States subsidiary does not affect the computation of the adjusted net book income of the subsidiary.[7]

(c) Applicability of Generally Accepted Accounting Principles

Certain issues not resolved by the proposed regulations may affect not only subsidiaries of foreign corporations, but also foreign corporations with United States branches to the extent that they are not permitted to use effectively connected earnings and profits as the basis for the book income adjustment. As is discussed in more detail below, see infra pp. 45-54, the proposed regulations in many instances make the tax treatment of a particular taxpayer dependent on compliance with United States generally accepted accounting principles ("GAAP").[8] It is unclear how these provisions apply to taxpayers that prepare their

[7] If some other result is intended, the Committee believes that the regulations should clearly so provide. A result other than the one set forth in the text, however, would be considerably more difficult to administer, inasmuch as it would require extracting the earnings of the United States subsidiary from the worldwide financial statement of its parent.

[8] The Committee questions, in some instances, the wisdom of these provisions for the reasons set forth below, see infra pp. 45-54. This discussion, however, assumes that the provisions at issue are retained and considers only how these provisions should be applied to foreign corporations.

financial statements in accordance with the accounting principles of a foreign country.

The dilemma that may be faced by a United States branch or subsidiary of a foreign corporation may be illustrated by an example. Consider a United States corporation the parent of which is incorporated in a country where accounting principles require that depreciation be computed on a sinking fund basis. If the United States corporation computes depreciation using a method acceptable under GAAP, it will have to provide to its parent additional disclosure to enable the parent to recompute depreciation for its own financial statements. Such additional disclosure may not be specifically authorized by GAAP, and hence, under section 1.56-1T(d)(5)(i) of the proposed regulations, the United States corporation might be forced to increase its adjusted net book income if the additional disclosure sets forth a higher number. Alternatively, the United States corporation might report its depreciation on a sinking fund basis, but, in this case, the United States auditors of the corporation would probably be able to issue only a qualified opinion. Under section 1.56-1T(d)(5)(iii) of the proposed regulations, a qualified opinion might require an increase in the taxpayer's adjusted net book income, if the opinion supports a calculation of a net book income amount greater than the amount explicitly set forth

in the financial statement. Under either procedure, therefore, the taxpayer may be forced, year by year, to use whichever method of depreciation produces a less favorable tax result in that year.

The proposed regulations are both unclear and potentially unfair in regard to the foregoing issues. In general, the Committee believes that United States subsidiaries (or, where relevant, branches) of foreign corporations should be able to substitute compliance with the accounting principles of the relevant foreign country wherever the proposed regulations call for compliance with GAAP. Adequate protection against the use of truly outlandish accounting methods would be provided by the requirement, which is contained in the proposed regulations, and which the Committee endorses, that a financial statement must actually be used for its purported purpose in order to qualify as the taxpayer's applicable financial statement. See Prop. Treas. Reg. 1.56-1T(c)(4), (c)(6) Example (4), Example (5).

(d) United States Corporation with Foreign-Source Income

The primary mechanism whereby the tax system seeks to ensure equitable treatment of United States taxpayers with foreign-source income is the foreign tax credit. The addition to the tax system of a broadly-based AMT, which includes a tax

based on financial statement income, immensely complicates foreign tax credit calculations. The proposed regulations, however, do not address foreign tax credit calculations by taxpayers subject to the book income adjustment.

The Committee infers that the Service intends to address the interaction of the AMT foreign tax credit and the book income adjustment when it supplies guidance concerning the AMT foreign tax credit. In this regard, Code Section 59(a)(1)(C) provides that any increase in AMT income attributable to the book income adjustment shall be deemed to have the same proportionate source and character as pre-adjustment AMT income. If pre-adjustment AMT income is negative, however, it may be impossible to calculate a meaningful ratio between the foreign and domestic components of pre-adjustment AMT income. In this situation, therefore, the rule prescribed by Code Section 59(a)(1)(C) may not be workable, and this Code Section therefore may require further elucidation by the Service.

3. Informal Communication of Financial Information

The proposed regulations provide reasonably detailed guidance concerning the effect of certain supplemental financial materials. Section 1.56-1T(d)(5)(i) of the proposed regulations provides that if a footnote or other supplementary

information to the taxpayer's applicable financial statement supports a calculation of a net book income amount higher than that explicitly set forth in the financial statement, then, with certain exceptions, net book income must be increased by the amount disclosed in the footnote or other supplementary information. Section 1.56-1T(d)(5)(iii) of the proposed regulations sets forth a similar rule, in cases where the taxpayer's applicable financial statement is a certified statement, governing the disclosure in the accountant's opinion accompanying the financial statement.

The Committee has certain reservations concerning the foregoing rules, relating to: (i) the application of these rules to United States subsidiaries of foreign corporations, discussed above, see supra pp. 25-27; and (ii) the requirements of these rules, in many cases, that taxpayers comply with GAAP. Subject to the foregoing qualifications, however, the proposed regulations provide rules that are generally workable in the case of footnotes and qualified accountant's opinions.

The proposed regulations leave considerable ambiguity, however, regarding other types of supplementary communication. In particular, the Committee is uncertain about the import of the term “other supplementary information” contained in section 1.56-1T(d)(5)(i) of the proposed regulations.

Examples of communications that may or may not fall within the scope of this section are oral statements at shareholders' meetings, press releases intended for financial analysts, or uncertified financial reports furnished by a subsidiary to its parent and intended primarily for internal managerial purposes.

Section 1.56-1T(d)(5)(i) of the proposed regulations, and the regulations as a whole, might be read as applying only to written information that is included as a part of, or that accompanies, the taxpayer's applicable financial statement. Such an interpretation would supply a “bright line,” ensuring that the Service would not have to monitor every corporate communication, which would be excessively intrusive and disruptive. Although the proposed regulations can be read as adopting such a “bright line” rule, the Committee believes that such a rule should be adopted more explicitly.

In addition, section 1.56-1T(d)(5)(i) is somewhat ambiguous in its reference to disclosure that “supports” a calculation of a higher net book income amount. The disclosure of financial good news that does not purport to constitute currently realized income (e.g., a favorable judgment in a lower court that is under appeal or a favorable contract to be carried out in later years)

should not give rise to additional book income; the proposed regulations should make this point clear.

C. Double Taxation Problems

Section 1.56-1T(d)(4) of the proposed regulations, promulgated pursuant to the legislative grant of authority contained in Code Section 56(f)(2)(H), addresses Congress' concern that an omission or duplication of items of income or expense would occur where an item is recognized either not at all or more than once in determining a taxpayer's adjusted net book income. Section 1.56-1T(d)(4) requires certain adjustments to be made to net book income but prohibits taxpayers from making any adjustments not expressly provided for in section 1.56-1T(d). As currently drafted, section 1.56-1T(d)(4) is not sufficiently flexible to address all of the circumstances in which an omission or duplication of items of income or expense may occur or to prevent, in the case of certain book-tax timing discrepancies resulting from the difference between GAAP and tax accounting principles, the imposition of the AMT upon previously-taxed income. Consequently, additional adjustments to net book income should be provided for by the proposed regulations in order to avoid taxing the same items of income more than once.

1. Subpart F Income

One situation where a duplication of an income item may occur, for which section 1.56-1T(d)(4) fails to provide clearly for an adjustment, is in the case of the repatriation of previously-taxed subpart F income of a controlled foreign corporation ("CFC"). Under Code Section 56(f)(2)(C)(ii) and section 1.56-1T(b)(2)(iv) of the proposed regulations, a taxpayer's adjusted net book income must include the earnings of its subsidiaries which are not consolidated for tax purposes only to the extent that amounts are required to be included in the taxpayer's gross income under Chapter 1 of the Code. Thus, a taxpayer must adjust its net book income to exclude all income of its foreign subsidiaries and then add back to net book income both dividends received from its CFC and its CFC's subpart F income. Prop. Treas. Reg. 5 1.56-1T(b)(6) Example (3), Example (4). As to the year of repatriation, Code Section 56(f)(2)(C)(ii) requires inclusion in book income of "amounts required to be included in gross income under this chapter in respect of the earnings of such other corporation" and thus appears to contemplate that the Code Section 959 exclusion from gross income for previously-taxed subpart F income should apply in the calculation of the book income adjustment. Because section 1.56-1T(b)(2)(iv) and (b)(6) Example (3) currently make no express

reference to the Code Section 959 exclusion, however, it is not clear that an adjustment corresponding to Code Section 959 will apply to the determination of book income. The Committee believes that the proposed regulations should clarify this point. If an adjustment corresponding to Code Section 959 were not applied in the determination of the book income adjustment, the same item of income would be taxed twice -- first when included in net book income as subpart F income and again when actually repatriated as a dividend to the CFC's domestic parent corporation.

2. Book-Tax Accounting Discrepancies

Another type of duplication of items occurs when an item of taxable income is accounted for prior to the corresponding book income or an item of book expense is accounted for prior to the corresponding tax deduction. These book-tax timing discrepancies arise because of the inherent tension between the principle of conservatism underlying most book accounting rules and the various special tax accounting rules designed to curb potential taxpayer abuses or enhance revenue. Consequently, there will be frequent cases where an item will be included in income for tax purposes prior to the time the taxpayer will be permitted under GAAP to report the income item for book income purposes, or an item will be expensed under GAAP prior to the time the taxpayer

is permitted a tax deduction. In these cases, an item of income that is included for tax purposes will be duplicated in a subsequent taxable year when the corresponding item of income is included in book income. Similarly, an item of expense that is a deduction under GAAP for book income purposes will be duplicated in a subsequent taxable year when the corresponding item of expense is deducted for tax purposes.

One example of the situation where an item of income will be included in taxable income and subsequently duplicated upon its inclusion in AMT income is the fact pattern found in Schlude v. Commissioner, 372 U.S. 128 (1963), where prepayments received by an accrual basis taxpayer in consideration of its promise to perform future services were held to be includible in taxable income upon receipt and not, as under GAAP, upon the performance of such services. The application of the AMT without an adjustment for an item of income which has been taxed previously under the regular tax system will result in the same item of income being taxed twice: first, under the regular tax system in the earlier year and second, under the AMT system in the later year.

Similarly, in those cases where a GAAP loss precedes the corresponding tax loss, a taxpayer may be subjected to the regular tax in the earlier year but will have book income in excess of taxable income in the later year (solely as a result

of the corresponding tax loss) and, thus, will be required to pay the AMT on the same item of income. This situation can be expected to arise, for example, where a book income reserve is allowed but no tax reserve is allowed (e.g., for bad debts, for future expenses of the type involved in Schlude, supra p. 34, for inventory write-downs as in Thor Power Tool Co. v. Commissioner, 439 U.S. 522 (1979), for deferred compensation accruals which are not deductible for tax purposes until paid, for capital losses in excess of capital gains, or for losses in nonrecognition transactions). A book reserve will reduce a company's book income but will not reduce its regular tax liability in the year it is established or increased. In the event that a book reserve is reversed because the reserved liability did not arise and, thus, must be reported as book income, it is particularly unfair to require the reversal of the reserve to be included in book income without allowing for a corresponding adjustment in the taxable year of the reserve reversal. This is particularly true in the case of the taxpayer who established or increased reserves prior to 1987 because such taxpayers received no benefit (i.e., a reduction in book income) as a result of the reserve but will have increased AMT income and will have to pay AMT in the taxable year of the reserve reversal.

The minimum tax credit allowed by Code Section 53 (“MTC”) provides a mechanism to integrate the book income adjustment and regular tax in the case of AMT resulting from certain deferral preferences but does not protect a taxpayer from double taxation resulting from the book income adjustment in those cases where taxable income precedes book income or book losses precede tax losses. Because there is no other offsetting credit against AMT for regular tax previously paid and the MTC is carried forward, not back to prior taxable years, a company will be required to pay the AMT without any credit for the regular tax already paid on the same item of income. Further, despite the availability of an MTC in the succeeding year that can be carried forward against future regular tax liability, the MTC is of no benefit unless the taxpayer returns to the regular tax system.

A special transition rule contained in Section 701(f)(5) of the 1986 Act provides a corrective adjustment to net book income for the benefit of one particular taxpayer (said to be Control Data Corporation) to eliminate the duplication of items resulting from the recognition of the same item under each of the tax systems in different taxable years. The special rule could be construed as Congressional acknowledgement and approval of the double taxation result for all other taxpayers. However, the rule may just as easily be interpreted as a benefit obtained

by a well-advised taxpayer which does not constitute evidence that Congress either intended or gave actual consideration to the double taxation result for other taxpayers.

Code Section 56(f)(2)(H) directs the Secretary to promulgate regulations to avoid the “omission or duplication of any item” and thus could be read to provide authority for regulations correcting the inequitable double taxation results occasioned solely by book-tax timing discrepancies. The Committee recognizes that Code Section 56(f)(2)(H) and the legislative history thereto may also be construed as requiring regulations to provide for such corrective adjustments to net book income only in those cases where the taxpayer's method of accounting results in the inclusion of the same item of income or expense more than once in the computation of adjusted net book income and not as requiring corrective adjustments in those cases where an item is recognized under one system (i.e., the tax system or the book system) in one taxable year and then is duplicated when recognized in a subsequent taxable under the other system. However, the Committee believes that the Service should give careful consideration to interpreting the regulatory authority somewhat more broadly to correct at least the most egregious of double taxation problems. The Committee does not believe that the existence of

the “Control Data” rule precludes such an exercise of authority. Furthermore, such regulations would be consistent with enhancing the real and perceived fairness of the tax system, which was one of Congress' principal motives in adopting the book income adjustment. See General Explanation, supra p. 16, at 434; S. Rep. No. 313, Supra p. 8, at 520.

The Committee believes that the situations in which taxpayers have the strongest claims for relief from double taxation are those in which both the following factors are present: (i) tax accounting rules require inclusion of an income item earlier than GAAP rules or recognition of a deduction item later than GAAP rules; and (ii) the earlier year was pre-1987, that is, one which was not subject to the book income adjustment or the lower tax rates under the 1986 Act. At least in these extreme situations the Service should seriously consider double taxation relief. The legislative history of the book income adjustment reflects a Congressional concern directed at the deferral or permanent avoidance of taxes. General Explanation, supra p. 16, at 433; S. Rep. No. 313, supra p. 8, at 521. The situation where a taxpayer recognizes income (and pays taxes thereon) prior to reporting such income under GAAP as the result of the differences between tax accounting and GAAP was not the

sort of problem which Congress sought to solve by enactment of the book income adjustment. Such a situation obviously is not abusive. On the contrary, it results from a special tax accounting rule which deviates from normal accrual principles and which requires income recognition earlier than would be permissible under conservative financial accounting standards. The Committee suggests that relief could be provided in the form of final regulations that trace previously-reported (under tax or GAAP) items of income or expense and permit an appropriate downward adjustment of book income by: (1) the amount of any items included in book income which were previously included in taxable income and (2) the amount of any items previously expensed for book purposes for which current tax deductions are being claimed. An approach such as this or some other attempt along a similar line, although not providing a precise solution in all situations and adding additional complexity, would in the Committee's view add an important element to the fairness of the AMT.

D. Corporation Acquisitions Using “Pooling” Accounting

The Committee believes that, in general, the application of the provisions of the proposed regulations in the context of corporate acquisitions will produce sound results. However, the Committee is concerned with the application of the proposed regulations to corporate acquisitions where a corporation

(the “Acquiring Corporation1”) acquires another corporation (the “Target”) in a transaction which, under GAAP, is accounted for by the pooling-of-interests method.

Under GAAP, a business combination which meets certain strict conditions is accounted for by the pooling-of-interests method (a “Pooling Transaction”). See Business Combinations, Opinion No. 16, $§ 45-48, 50 (Accounting Principles Bd. 1970) [hereinafter APB Opinion No. 161. Among these conditions is a requirement that the reported results of operation for the Acquiring Corporation (i.e., its income statement) for the accounting period in which the Pooling Transaction was consummated account for such period as though the Acquiring Corporation and the Target had been combined as of the beginning of the accounting period.[9] Id. § 56. Thus, the income of the combined group comprising the Acquiring Corporation and the Target (the “Combined Corporation”) for the accounting period in which the Pooling Transaction occurred includes the Target's pre-acquisition as well as post-acquisition income.[10]

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[9] For simplicity of illustration we have assumed that the Acquiring Corporation and the Target use the same fiscal year.

[10] The Combined Corporation must disclose in notes to its financial statements the revenue, extraordinary items, and net income of the Acquiring Corporation and the Target on a separate basis for that portion of the accounting period prior to the consummation of the Pooling Transaction. APB Opinion No. 16, supra p. 40, § 56. Balance sheets and other financial information of the Combined Corporation must similarly be presented. Id. § 57. In addition, financial statements and financial information presented for prior years of the Acquiring Corporation and the Target must also be restated on a combined basis in order to furnish comparative information. Id. No adjustment to the Acquiring Corporation's net book income is allowed under the proposed regulations, however, because section 1.56-1T(d)(5)(i)(A)(1) does not allow for adjustment in the case where, as in a Pooling Transaction, the footnote disclosure is specifically authorized by GAAP.

The Target's own financial statements and tax return would, of course, also include the pre-acquisition period. Thus, there is a duplication of the Target's net book income for the pre-acquisition portion of the acquisition year. The Committee believes that an adjustment to net book income is within the regulatory authority of the Treasury Department pursuant to Code Section 56(f)(2)(H) and is necessary and appropriate in this instance. Without such adjustment, the operation of APB Opinion No. 16 and the proposed regulations as currently drafted will result in the duplication or omission of items of income and expense. Thus, an Acquiring Corporation would increase its adjusted net book income and its AMT if it acquired a Target with net book income in a Pooling Transaction and could reduce its exposure to AMT by acquiring a Target with net book losses.

In order to avoid such obvious duplication or omission, the Committee strongly suggests that final regulations

provide specific rules and examples to deal with the treatment of Pooling Transactions, as is apparently required by Code Section 56(f)(2)(H). Such an amendment to achieve the avoidance of duplication or omission of items could be accomplished by: (1) amending section 1.56-1T(d)(5)(i) to allow for adjustments to net book income by the amount of the Target's separately-stated net book income, as disclosed in footnotes pursuant to APB Opinion No. 16, paragraphs 51-65 and (2) amending section 1.56-1T(d)(4)(iv)(E) to provide specifically that it does not apply to a deemed restatement of an applicable financial statement triggered by the application of section.1.56-1T(d)(4)(iv)(B), described below, see infra note 11.

Apart from this general recommendation as to double inclusion in a Pooling Transaction, the Committee wishes to raise two specific drafting points. First, section 1.56-1T(d)(4)(iv)(A) sets forth the general rule requiring net book income to be adjusted if a taxpayer restates an applicable financial statement. A specific exception to this general rule is found in section 1.56-1T(d)(4)(iv)(E), which provides: “No adjustment [to net book income] is made under paragraph (d)(1)(iv)(A) of this section [1.56-1T] for a restatement prepared in accordance with APB Opinion No. 16, paragraph 53, requiring restatements of

financial statements to reflect the combined operation of corporations combined in a pooling transaction."

Because this exception appears to be operative only with respect to "restatements" required by GAAP to reflect a Pooling Transaction, the proposed regulations do not appear to address directly whether any adjustment to net book income is required where the initial applicable financial statement of the Acquiring Corporation for the year of acquisition has been prepared in accordance with APB Opinion No. 16 to reflect a Pooling Transaction. The Committee believes that the meaning of "restatement" in this context should be clarified.[11]

Second, the Committee observes in connection with section 1.56-1T(d)(4)(iv)(E) that the accounting rules applied to a Pooling Transaction are contained in paragraphs 51

[11] Any such clarification should take account of section 1.56-1T(d)(4)(iv)(B). In general, that section creates a "deemed restatement" of an applicable financial statement if the beginning balance of owner's equity on the taxpayer's applicable financial statement for the current taxable year is different than the ending balance of owner's equity on the preceding taxable year's applicable financial statement. Thus, in a Pooling Transaction, a deemed restatement of the Acquiring Corporation's applicable financial statement and a resulting adjustment to net book income could be required in a Pooling Transaction because the owner's equity for the current taxable year and previous taxable year (not taking into account, under section 1.56-1T(d)(5)(i)(A)(1), footnote disclosure for prior years pursuant to APB Opinion No. 16, paragraph 57) would be different.

through 65 of APB Opinion No. 16 and not solely in paragraph 53. For example, paragraph 56 of APB Opinion No. 16 provides the specific authority for restatement of earnings for the preacquisition portion of the accounting period; paragraph 57 provides for restatements of prior years on a combined basis in order to furnish a basis for comparison of prior years with the year of the acquisition. Although paragraph 56 of APB Opinion No. 16 is included by reference in paragraph 53, paragraph 57 is not. Thus, it is unclear whether section 1.56-1T(d)(4)(iv)(E) prohibits adjustments to book income for restatements required solely by paragraph 53 of APB Opinion No. 16 or whether adjustments to book income are not to be made in any case where a restatement is required under APB Opinion No. 16 to reflect a Pooling Transaction. The Committee believes the latter conclusion is the correct interpretation of section 1.56-1T(d)(4)(iv)(E). Otherwise, the proposed regulation could be construed as requiring the Acquiring Corporation and the Target to amend prior years' returns to show adjustments to book income if the restatement, although occasioned by a Pooling Transaction, is required specifically by a Pooling Transaction rule not contained in paragraph 53. The Committee would suggest either that section 1.56-1T(d)(4)(iv)(E) be amended either to delete the reference to paragraph 53 (the Committee's first choice) or to change the reference to paragraph 53 to “paragraphs 51-65”

so as to include the full set of rules contained in APB Opinion No. 16 which control the reporting requirements for a Pooling Transaction.

E. Excessive Requirements of Compliance with Generally Accepted Accounting Principles

The Committee is somewhat troubled by the fact that, in numerous instances, the proposed regulations make the determination of adjusted net book income dependent on the requirements of GAAP. These provisions of the proposed regulations may produce the result feared by many who opposed the enactment of the book income adjustment provisions, namely, that the Service and the courts, rather than the accounting profession, will become the arbiters of what constitutes compliance with GAAP. See, e.g., Committees on Alternative Minimum Tax and Corps., N.Y. State Bar Ass'n Committee, The Senate's Proposed Book Income Minimum Tax Preference, reprinted in 32 Tax Notes 569 (1986); see also Sheppard, The Book Income Preference in the Corporate Minimum Tax, 33 Tax Notes 616 (1986) (reporting concerns of the General Accounting Office and the Financial Accounting Standards Board).

It was in order to alleviate those fears, presumably, that the Senate Finance Committee, after enumerating a small

number of specifically described instances in which adjustments other than those specified in the Code might be made to financial statement income, stated: “The [C]ommittee does not intend otherwise to interfere with the choice of a reasonable accounting method of the taxpayer, to require that certain accounting principles be applied, or to establish the Secretary of the Treasury as an arbiter of acceptable accounting principles.” S. Rep. No. 313, supra p. 8, at 534. Supporters of the book income provisions have expressed similar sentiments.

Notwithstanding the directive of the Senate Finance Committee, the proposed regulations will in many instances require that the Service become “an arbiter of acceptable accounting principles.” Examples are numerous. Section 1.56-1T(c)(1)(ii) of the proposed regulations may require the Service to determine whether an accountant is “independent” within the meaning of section 101 of the Code of Professional Ethics of the American Institute of Certified Public Accountants. Section 1.56-1T(c)(5)(iii)(B)(2) may require the Service to determine what constitutes an “error” within the meaning of paragraph 13 of Opinion No. 20 of the Accounting Principles Board. Section 1.56-1T(d)(5)(i)(A) of the proposed regulations may require the Service to determine whether a particular footnote disclosure is

"specifically authorized by the accounting literature," and section 1.56- 1T(d)(S)(ii)(A) may likewise require the Service to determine whether an equity adjustment is "specifically authorized by the accounting literature."

The Committee understands the apparent desire on the part of the Service to prevent taxpayers from manipulating their tax liability, with no external or objective restraint other than the integrity and judgment of the accounting profession. In the context of the book income adjustment, however, the Service's concerns are misplaced. The book income adjustment provisions of the Code are intended to prevent companies from reporting substantial earnings while paying little or no tax. S. Rep. No. 313, supra p. 8, at 520. This objective is equally well achieved if a corporation incurs tax liability, or if it does not report income, regardless of whether the failure to report income complies with GAAP.[12]

Furthermore, the approach taken by the proposed regulations will immensely complicate the administration of the tax law. For example, Examples (3) and (4) of section 1.56-1T(d)(5)(v) of the proposed regulations state, in effect, that adjusted net book income need not be increased to reflect equity adjustments

[12] The Committee of course does not intend to condone the failure to comply with GAAP, but merely to point out that it is not the job of the Service to police such compliance.

attributable to foreign currency translation gains, but must be increased to reflect equity adjustments attributable to foreign currency transaction gains, because the Financial Accounting Standards Board requires foreign currency transaction gains to be included in income, but requires foreign currency translation gains to be treated as equity adjustments. See Foreign Currency Translation, Statement of Financial Accounting Standards No. 52, §§ 13, 15 (Fin. Accounting Standards Bd. 1981). In fact, however, there are several exceptions to the requirement that foreign currency transaction gains must be included in income determined under GAAP. For example, foreign currency gains from certain hedging transactions are accounted for as equity adjustments, rather than as items of income. Id. § 20. The proposed regulations threaten, therefore, to create a new body of case law concerning such issues as which transactions qualify, for book income purposes, as "transactions that are designated as, and are effective as, economic hedges of a net investment in a foreign entity . . . ." See id.

Accordingly, the Committee believes that the Service should adopt a more objective approach. The proposed regulations should focus not on whether a particular method of reporting is in accordance with GAAP, but on whether the person who certifies the financial statement (or the person who distributes or files

an uncertified statement) is willing to state that the statement is in accordance with GAAP, and the recipient is willing to accept the statement. Certainly in the case of a financial statement filed with the SEC, or furnished to a lender or a governmental unit, no matter how imperfect the statement may be, there is no compelling reason for the Service to substitute its judgment for that of the recipient of the statement.

It might be possible to read the provisions of the proposed regulations requiring compliance with GAAP as applying only to uncertified financial statements not filed with the SEC, inasmuch any certified statement, or any statement filed with the SEC, is, at least prima facie, in compliance with GAAP. Such a reading of the proposed regulations would greatly reduce the Committee's concern that the Service may become an arbiter of acceptable accounting principles. The proposed regulations nowhere state, however, that compliance with GAAP will be monitored only in the case of uncertified statements. The Committee believes that the proposed regulations should at least provide that in the case of a statement filed with the SEC, any certified statement, or a statement furnished to a governmental unit, where compliance with GAAP is an issue, there will be a presumption (if not an absolute rule) that the statement is in compliance with GAAP. Such a

presumption would fulfill the legislative intent that the Service not become enmeshed in resolving financial accounting issues.

A more objective approach would also reduce the vagueness of the proposed regulations. As currently drafted, the proposed regulations supply little meaningful guidance in many instances. For example, the proposed regulations permit certain practices or procedures if they are “specifically authorized by the accounting literature”; the term “accounting literature” is defined through a series of cross-references to include “[p]ractices or pronouncements that are widely recognized as being generally accepted because they represent prevalent practice in a particular industry or the knowledgeable application to specific circumstances of pronouncements that are generally accepted . . . .” See Prop. Treas. Reg. § 1.56-1T(d)(2)(ii) (defining “accounting literature” by reference to the Professional Standards issued by the American Institute of Certified Public Accountants); Am. Inst. of Certified Pub. Accountants, AICPA Professional Standards, Statements on Auditing Standards § 411.05 (1982) (defining sources of authority in the language quoted). It is unclear how something can be “specifically authorized” by anything so vague as a “prevalent practice” or a “pronouncement . . . widely recognized . . . as knowledgeable.”

Under the objective approach advocated by the Committee, the Service would not, for example, investigate whether a financial statement is being amended as the result of an error within the meaning of paragraph 13 of Opinion No. 20 of the Accounting Principles Board. Assuming that the Service retains the rule, which was questioned earlier in this report, see supra pp. 12-17, that an amended financial statement does not necessarily supplant an earlier statement unless the amendment is made in order to correct an error, the Service should nonetheless treat any financial statement as the correction of an error if the financial statement purports to be such.

Regarding the issue of footnote disclosure, section 1.56-1T(d)(5)(i) provides that adjusted net book income must be increased (but not, apparently, decreased) by any amount disclosed in a footnote, if the footnote supports a calculation of a net book income amount greater than that reported on the taxpayer's applicable financial statement. Net book income need not be increased, however, if the disclosure is either specifically authorized by GAAP, or is in accordance with the taxpayer's historic practice.

The Committee believes that the additional complexity and administrative difficulty that will arise from the necessity of determining whether a particular item of disclosure is

specifically authorized by GAAP outweigh whatever modest increase in fairness might result from the rule contained in the proposed regulations. As noted previously, see supra p. 30, the Committee believes that a “bright line” rule should be established, under which written statements issued as part of the taxpayer's applicable financial statement should be considered in the calculation of adjusted net book income, and other communications should not be considered. In the case of written statements issued as part of the taxpayer's applicable financial statement, the Committee believes that all such statements should be considered in the calculation of adjusted net book income, without regard to whether the statement is authorized under GAAP.

Regarding equity adjustments, the Committee notes the dilemma faced by the Service, which must confront a difficult issue aided only by some cryptic legislative history. The Senate Finance Committee report states: “It is anticipated that [regulations will be issued] to prevent the recording of items directly to the financial statement asset, liability, or equity accounts that are properly included as items of financial statement income or expense.” S. Rep. No. 313, supra p. 8, at 534. The import of the word “properly” in the quoted language is somewhat unclear. In particular, it is unclear whether Congress intended, as a general rule, that any equity adjustment

should be treated as an item of book income, inasmuch as, from an economic perspective, any such adjustment does normally represent income,[13] or whether Congress intended only that those equity adjustments that are “improper,” under some undefined standard, should be treated as items of income.

Section 1.56-1T(d)(5)(ii) of the proposed regulations apparently adopts the latter interpretation, and provides that net book income must be increased by the amount of any equity adjustment, unless the adjustment is either specifically authorized by the accounting literature (i.e., generally, the adjustment is in accordance with GAAP) or is in accordance with the taxpayer's historic practice. The proposed regulations apparently do not permit a taxpayer to decrease its net book income to reflect any downward equity adjustment.

This provision is objectionable both because of its reliance on the standard of GAAP, and because it operates only in one direction. A fairer and more objective (and, hence, more easily administrable) rule would be preferable. Accordingly, the Committee suggests that the proposed regulations should provide that net book income shall be either increased or decreased,

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[13] An equity adjustment normally represents an accession to wealth, and thus, under general principles, is includible in income.

as appropriate, to reflect any equity adjustments in the taxpayer's applicable financial statement, without regard to whether the equity adjustment is proper under GAAP. Such a rule would eliminate disputes over the application of GAAP to particular cases. In addition, by permitting downward adjustments to net book income when appropriate, the rule proposed by the Committee would make adjusted net book income a better measure of the change in the taxpayer's economic status reported in the taxpayer's applicable financial statement. Any potential for abuse would be limited, for several reasons. First, sophisticated users of financial statements presumably give due weight to equity adjustments, just as they would to items reported in income. Second, any equity adjustment (unlike an amount disclosed in a footnote) will frequently be balanced, over time, either by an amount reported as an item of income or loss, or by another equity adjustment that reverses the first adjustment.

Additionally, with regard both to footnote disclosures and to equity adjustments, the Committee believes that the references to disclosures or adjustments “authorized” under GAAP are overly broad. If there is to be an exception permitting some footnote disclosures or equity adjustments to be excluded from adjusted net book income, this exception should be limited to footnote disclosures or equity adjustments required, not merely authorized, under GAAP.

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