New York State Bar Association

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NYSBA

December 22, 1995

BY FEDERAL EXPRESS

Glen A. Kohl, Esq.
Tax Legislative Counsel
Department of the Treasury
1500 Pennsylvania Ave., N.W.
Washington, D.C. 20220

Re: **Administration's December 1995 Tax Proposals**

Dear Glen:

I am enclosing for your review a memorandum that sets forth comments of members of the Tax Section on the Administration's recent proposals to amend certain provisions of the Code. These proposals were set forth in the description of the President's seven-year balanced budget proposal, released by the Treasury on December 7, 1995, were modified somewhat by press releases issued December 11 and December 19, 1995, and are described in the Joint Committee Staff's December 15, 1995 Description (JCX-5B-95) (collectively the "December proposals"). Drafts of the proposed legislative provisions have not yet been released, nor has any detailed description of the proposals. We are therefore commenting on the proposals based on the descriptions provided in the December proposals. (A copy of the December 7 description is attached.)

We have endeavored to limit our comments to technical issues. We do not discuss overarching policy issues raised by the proposals, although clearly a number of such issues are inherent in the proposals. These issues should be fully and carefully considered. Our time constraints, however, required that we refrain from commenting on whether the different proposals should be enacted, and our memorandum is not intended to comment, pro or con, on the merits of the proposals.

In submitting these comments to you I want to express certain concerns we have about this process. Obviously, we would have preferred to review proposed statutory language, for that would have much more

precisely defined the scope of the proposals, and likely would have resolved many of the questions raised in the memorandum. We also would have preferred having sufficient time to present a report to our Executive Committee for review and approval, for we find that process of collaborative analysis particularly effective in identifying and resolving issues. We perceive, however, a real possibility that the December proposals will be reduced to legislative language and enacted within a very short period of time. Moreover, the difficulty of enacting technical corrections, evident again in this year's budget process, underscores the importance of identifying and resolving at this time as many technical issues as possible. The Executive Committee therefore concluded that, as with last year's GATT legislation, it would be useful to provide you with the enclosed commentary, even though neither the December proposals nor our comments have enjoyed the optimal gestation period.

We are concerned about the number of changes proposed to be made effective as of the date of their announcement. Many of the proposed changes do not close loopholes, but instead alter long-standing rules that were knowingly established by the courts or past Congresses, and that have existed in the tax law for many years without bringing the system to its knees. In proposing immediately effective changes to such rules, without debate as to their policy merits or detailed descriptions of the proposed provisions, the December proposals subordinate the long-term integrity of the tax law to short-term logistical pressures. The announcement of immediately effective changes in long-standing rules also has an untoward effect to the extent such proposals are not enacted, for the announcement may prevent legitimate transactions that ultimately are unaffected by the tax bill from proceeding while the proposal is under consideration.

We also believe that the difficulty of commenting under these conditions makes it more likely that those with financial interests in the outcome enjoy a disproportionate voice in the process, for they are able to devote their full energies to their cause, whereas organizations like ours depend on the goodwill and pro bono inclinations of our members (which are considerable). When time is short and the legislative process confusing, the opportunities to hear from persons with no compelling economic interest in the

outcome is considerably reduced. We recognize that this timetable is not of your making, and that in the current environment pleas for more time may be Sisyphean. Nevertheless, it is important to be aware of the unfortunate, and in some senses counter-productive, side effects of unduly rushing legislation.

We know that you are devoting enormous energies to produce bills that are technically sound and satisfy the desired policy objectives, and we commend your staff and the Congressional staffs for their consistent excellence and their perseverance under these pressures. We hope the enclosed comments are useful to you, and we are willing and available to be of further assistance as the proposals are refined. The memorandum identifies the principal authors of each segment of our comments -- I encourage you to contact me, the other Tax Section officers, or any of these authors should you wish to discuss these comments in greater detail.

Very truly yours,

Carolyn Joy Lee
Chair

cc: Kenneth J. Kies, Esq.
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NEW YORK STATE BAR ASSOCIATION
TAX SECTION

Technical Comments on Certain of the Administration's Tax Proposals of December 7, 1995

December 22, 1995

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i. For purposes of determining "maximum term", a holder or issuer right to extend should be deemed exercised if exercise of such right is pursuant to the original terms of the instrument. Cf. Prop. Treas. Reg. §1.1001-3(c)(2)(i).

ii. In general, if extension would result in a realization event under Section 1001, we believe that the period after extension should be disregarded in determining "maximum term".

iii. However, there may be circumstances in which the term of a refinancing pursuant to arrangements that were in place at the time of original issuance should be taken into account in determining the maximum term of a debt instrument. Cf. Section 163(i)(5)(B).

b. Weighted Average Maturity

i. Consideration should be given to determining maximum term based on weighted average maturity rather than last payment date.

ii. For example, under a last payment date rule, a 39-year zero coupon bond would not be subject to automatic interest disallowance under the proposal, while a 41-year self-amortizing bond apparently would be.

2. Is a debt instrument subject to the proposal still treated as debt for other purposes, including, for example, the portfolio interest exemption?

3. Consideration should possibly be given to bifurcating (only for purposes of applying the proposal) a self-amortizing debt instrument with a maximum term of more than 40 years into two instruments, one with a maximum term of no more than 40 years and one with a maximum term of more than 40 years. Then, only the interest on the latter piece would be disallowed. For example, if a loan requires the borrower to repay at least 80% of the principal amount of the loan within 40 years of its issuance, only the interest related to the 20% of the principal that could remain outstanding for more than 40 years would be disallowed.

B. Debt Instruments Payable in Stock of the Issuer or a Related Party

1. In general, under the proposal an instrument would not be considered to be payable in stock merely because the holder has a right to be paid in, or convert into, stock.

   a. For example, an instrument would not be considered to be payable in stock merely because the holder can choose between $1000 in cash and stock of the issuer with a value of $1000.

   b. What is the treatment of a security where the issuer has the right to pay the $1,000 principal amount of a debt instrument in either $1,000 cash or $1,000 worth of the issuer's stock, if holders have the right to (i) force the issuer to sell for cash (generally through secondary market sales) stock worth $1,000 and (ii) enforce an unconditional claim against the issuer to receive cash equal to any shortfall between $1,000 and the proceeds from the sale of the issuer's stock (assuming such right is enforceable, including in a bankruptcy setting)? See Rev. Rul. 85-119, 1985-2 C.B. 60.

2. If it is substantially certain at the time of issuance that the holder's right will be exercised, the proposal provides that the instrument would be considered to be payable in stock, notwithstanding the holder's unconditional right to receive payment in cash.

a. For example, if the holder can choose between $1000 in cash and stock of the issuer with a value of $1500 at the time of the issuance of the debt, the instrument generally would be considered payable in stock. See Rev. Rul. 83-98, 1983-2 C.B. 40.

b. While normally a convertible debt instrument with a conversion price that is "deep in the money" at the time of issuance would likely be considered to be payable in stock, is that true if the issuer assumes a convertible obligation which was not deep in the money when issued but is at the time of the assumption? In this context, it might be relevant whether the assumption was incident to a tax free reorganization described in §368.

c. What presumption, if any, would apply if the holder has the right to convert into preferred stock with a higher yield than the debt instrument? Cf. Treas. Reg. § 1.1272-1(c)(5); Treas. Reg. § 1.305-5(b)(3).

3. If two debt instruments are issued by a corporation as part of the same transaction, with one payable in stock of the issuer and the other not payable in stock, would the two instruments be treated as a single instrument, with the result that no interest on either instrument would be deductible? Cf. Reg. § 1.1275-2(c).

4. Is a debt instrument subject to the proposal still treated as debt for other purposes, including, for example, the portfolio interest exemption?

5. What would the treatment be of instruments that are partially payable in stock and partially payable in cash, such as instruments under which the principal is required to be paid in cash and the interest may be paid in stock?

C. Debt Instruments With a "Maximum Term" in Excess of 20 Years Not Shown as Debt on a Financial Statement

1. The proposal states that certain 20-year debt is treated as equity to the issuer for purposes of Section 385(c). Can holders nevertheless still take the position that such instruments are debt, if they otherwise pass muster under Section 385? If so, it is not clear why an issuer of a debt instrument described in this Part I.C. is required

to withhold tax from payments as though such payments were dividends. If such instruments are in fact debt, holders could obtain refunds. Further, if instruments described in Parts I.A. and B are still considered debt, issuers of such instruments could apply the portfolio interest rules to avoid withholding.

2. The comments in Part I.A.1.a. above regarding determination of the maximum term of a debt instrument also apply to debt instruments described in this Part I.C.

3. The proposal should clarify which balance sheet filed with the S.E.C. is the relevant balance sheet for determining the issuer's characterization of the instrument.

   a. Generally, in connection with a public offering, the prospectus or prospectus supplement filed with the S.E.C. as part of the registration statement contains at least an abbreviated balance sheet of the issuer. Should that balance sheet, which is the issuer's most current balance sheet on the date of issuance, be used to determine characterization or should the balance sheet contained in the issuer's next filed Form 10K or Form 10Q be used?

   b. If instruments are sold pursuant to an unregistered offering (e.g., a Rule 144A offering), the balance sheet included in the offering circular is generally not filed with the S.E.C. Accordingly, the relevant balance sheet would generally be the first balance sheet filed by the issuer following the issuance of the securities.

4. The proposal should clarify the meaning of "shown as indebtedness" on a balance sheet. In the case of an instrument that is not labeled debt or equity, the proposal should address the significance of the name of the instrument and the instrument's placement on the balance sheet.

   a. For example, in the case of an instrument issued to a related noncorporate party, if the related party instrument is described as "Company-obligated mandatorily redeemable preferred securities of a trust", would characterization as debt depend on whether such instrument is placed above or below the

"total indebtedness" or "total borrowings" line on the balance sheet?

5. In the case of instruments issued to a partnership or trust, the proposal should clarify who is the "holder" for purposes of Section 385(c)(2).

   a. Presumably, if the debt is issued to a partnership, including a partnership related to the issuer, the partnership is the holder.

   b. If instruments that are issued to a trust are characterized as equity from the issuer's perspective, and the trust issues trust preferred securities to the public, who is the "holder" for purposes of Section 385(c)(2)? If the holder is the trust, then the trust could make a single inconsistent treatment election for all the public holders and disclose such inconsistent treatment on its annual trust tax return filed on Form 1041.

6. Would instruments described in this Part I.C. be viewed as affording holders creditors' rights with the result that corporate holders would not be entitled to the dividends received deduction? See Rev. Rul. 94-28, 1994-1 C.B. 86.

7. In the event that a debt instrument is issued to a related corporation (e.g., a related non-U.S. corporation that does not pay U.S. tax on interest income from the debt instrument), why is the separate balance sheet of the issuer more relevant than the consolidated balance sheet?

8. Would a change in the financial accounting treatment of an instrument not associated with a Section 1001 event change the issuer's characterization of the instrument?

   a. Such a change in financial accounting treatment might result either from a change in accounting rules or a change in the identity of the holder of the instrument.

   b. A rule that takes such changes in financial accounting treatment into account will be favorable to taxpayers in some circumstances but unfavorable in other circumstances.

9. Would the proposal apply to asset-backed securitization transactions? Would the proposal

apply only to debt instruments or would it also apply to long-term leases, short sales and combinations of financial instruments that are economically similar to debt?

II. Modification of Holding Period for Dividends Received Deduction

A. On what date is the taxpayer "entitled" to receive the dividend? On the corporation's record date? On the stock exchange's ex-dividend date? Cf. Section 246(c)(3)(B).

III. Application of Section 265 Proration Rule to All Corporations

A. If two entities are related, but not members of the same consolidated group, the tracing rules would continue to apply. Thus, if outstanding debt of one entity can be traced to the other entity's tax-exempt assets, deduction of interest on such debt would be disallowed. Any such traced debt of the first entity should be excluded from application of the pro rata disallowance rule to avoid double disallowance of the same interest.

B. Would District Directors have discretion to aggregate taxpayers that are under common control (but not members of the same consolidated group) in applying the pro rata disallowance rule? See Rev. Rul. 90-44, 1990-1 C.B. 54, 57 (granting such discretion under the pro rata rule applicable to banks under current Section 265(b)).

C. The proposal would treat all members of a consolidated group as a single entity. Under current Section 265(b), banks that are members of a consolidated group generally pro rate interest on a separate company basis. See Rev. Rul. 90-44. The proposal would, therefore, change the treatment of such banks.

D. Under current Section 265(b), shares in a regulated investment company that pays exempt interest dividends are treated as tax exempt obligations. See Section 265(b)(4)(B). Presumably, the same rule would apply under the proposal.

E. Should interest expense subject to disallowance reflect expense or income from notional principal contracts or other financial instruments used by taxpayers to hedge their borrowings? Cf. Reg. § 1.861-9T(b)(6).

F. Would financial institutions subject to current Section 265(b) continue to be eligible for the small issuer exception of current Section 265(b)(3)?

G. Are there any noncorporate financial institutions subject to current Section 265(b)? If so, how would such institutions be treated under the proposal?

H. If a parent corporation owns less than 100% of the stock of a consolidated subsidiary, would only a proportionate part of the subsidiary's assets and liabilities be aggregated with the parent's assets and liabilities?

I. Would a corporation's assets include its equity in other taxpayers that are related parties but not members of the same consolidated group?

J. Are there any circumstances in which corporations should be permitted to use fair market value of assets rather than tax basis in applying the pro rata allocation rule? Cf. Section 1059(c)(4).

K. Should taxpayers be permitted or required to net interest income against interest expense from a "matched book" of repurchase agreements in determining the amount of interest expense subject to disallowance?

Technical Comments on Proposal to
Treat Certain Preferred Stock as "Boot"

1. Complexity. Unlike some of the other proposals, the preferred-stock-as-boot proposal would increase complexity in the tax law by, among other things, (i) creating a new distinction between preferred stock that is treated as boot for purposes of Sections 351 and 356 ("Disqualified Preferred") and other preferred stock, (ii) creating exceptions to this rule that require comparing the value and terms of preferred stock received to the value and terms of preferred stock or debt surrendered, (iii) differentiating "family-owned" corporations from other parties to a reorganization, and (iv) suggesting the creation by regulations of "installment sale" type rules for Disqualified Preferred. Given the consequences of running afoul of the rule, if a proposal of this type is pursued, we recommend consideration be given to reasonable steps that can minimize complexity and make the provision more "user friendly," including the articulation of clear and accessible safe harbors.

2. Basic Rule

   a. As we read the proposal, stock that includes a conversion privilege will be treated as participating in corporate growth and thus will not be treated as Disqualified Preferred. (This differs from Section 305(b)(4) and the regulations thereunder, which treat convertible preferred as preferred.) More clarification of this rule is, however, needed. Is the description of preferred stock as "stock that is limited and preferred as to dividends" intended to be identical to the language of Section 1504(a)(4)(B)? Consideration also should be given to providing guidance as to the treatment of conversion features that lack substance and thus may be disregarded. See Reg. §1.305-5(a).

   b. Would the safe harbor for certain preferred stock that is not puttable, callable or mandatorily redeemable for at least 20 years permit any acceleration events that frequently are found in preferred stock instruments (e.g., liquidation or insolvency of the issuer, sale of its assets, change of control of the issuer)?

   c. Would stock be considered puttable, callable or mandatorily redeemable if it was subject to, for example, a buy-sell right?

d. Regarding the inclusion of preferred stock that is callable if, "as of the date of issue, it is more likely than not that the [call] right will be exercised," we will need guidance as to when it will be "more likely than not" that a call right will be exercised. The recently issued regulations under Section 305(c) would be a useful starting point.

3. Scope

a. We assume the preferred-stock-as-boot proposal is not intended to exclude Disqualified Preferred from the basic "control" definition of Section 368(c), although the proposal is not clear on this point.

i. For example, assume A contributes appreciated property to corporation X for X common stock representing 70% of X's voting power, B contributes cash for X voting preferred stock representing 10% of X's voting power (so that A and B together own X stock constituting "control"), and C owns "old and cold" X common stock representing the remaining 20% of X's voting power. Assume that under the proposal, the preferred would be Disqualified Preferred. Presumably the preferred would continue to be taken into account for purposes of determining Section 368(c) control. Otherwise, A's exchange would not qualify under Section 351, in contrast to current law.

ii. Conversely, assume A transfers property for 80% of X's common stock but B owns preferred (with 50% of the vote) which B previously acquired in a transaction in which the preferred stock was Disqualified Preferred. Presumably B's preferred stock would be taken into account under Section 368(c). Otherwise, A's exchange would qualify under Section 351, in contrast to current law.

b. Similarly, would Disqualified Preferred be counted for purposes of determining what is a "D" reorganization, where the Section 304(c) definition of control applies?

c. Would voting preferred stock that is Disqualified Preferred count as "voting stock" for purposes of Sections 368(a)(1)(B), 368(a)(1)(C) and 368(a)(2)(B)?

d. Would Disqualified Preferred count for continuity of interest purposes? For example, if Corporation X merges into Corporation Y and 80% of the consideration received by X's shareholders is voting Disqualified

Preferred, is continuity violated (in contrast to current law)?

e. What changes to Section 318 are contemplated by the penultimate sentence of the proposal? If changes to Section 318 are anticipated, should other attribution rules (e.g., Section 267) also be changed?

4. Exceptions

a. The proposal would exclude "an exchange of preferred stock for comparable preferred stock of the same or lesser value."

i. Does the reference to "comparable" mean that, even if the old and new preferred stocks have the same value, the exclusion may not apply?

ii. In order to minimize difficult valuation issues, consider a safe harbor exempting exchanges of preferred stock if the terms of the old and new preferred are sufficiently similar (e.g., same term, same principal amount and same dividend rate), even if the stocks may have different values (e.g., because they have different issuers with different credit positions).

iii. Guidance is needed as to when the values are measured (e.g., when an offer of preferred stock is announced, when the preferred stock is issued, etc.).

iv. This exclusion raises issues similar to those relevant to exchanges of debt securities under Section 356. See generally NYSBA Tax Section, Committee on Reorganizations, Report on "Excess Principal Amount" of Securities Under Section 356 (January 31, 1995) ("NYSBA Section 356 Report").

b. The proposal would exclude "an exchange of debt securities for preferred stock of the same or lesser value as the adjusted issue price of the debt." This rule, literally applied, would create taxable gain whenever an appreciated debt security is surrendered for preferred stock with a value above the debt security's adjusted issue price, even if the debt and preferred have the same value. This would be particularly harsh if, for example, the new preferred and the old debt had substantially the same terms. For an analysis of this difficult issue in connection with the receipt of debt securities in a reorganization under Section 356, see NYSBA Section 356 Report.

c. The proposal would exclude "an exchange of preferred stock for common stock." This exclusion is confusing. If it is intended to exclude an exchange of old preferred for new common, it appears unnecessary, because common stock is not boot under current law. If it is intended to exclude an exchange of old common for new preferred, it appears to be fundamentally inconsistent with the basic preferred-stock-as-boot rule.

d. The proposal refers to Section 447(e) and then describes that provision in terms more narrow than Section 447(e). Presumably the actual bill language will refer to Section 447(e), without reducing its scope. Query whether, given the eight-year time span applied in the proposal, "family" should also include former spouses. The exclusion for stock as to which a nonfamily member has "a right, option or agreement to acquire the shares" again raises the question of the effects of a buy-sell agreement (including one with the corporation).

e. It is not clear to which "certain" recapitalizations the family corporation rule applies.

5. Other Considerations

a. We support the suggestion of "installment sale" type rules for Disqualified Preferred Stock and recommend that the legislation specifically require that such rules be adopted in connection with the basic preferred-stock-as-boot rule. Otherwise, the rule could discourage the issuance of currently-taxable preferred in connection with a Section 351 or 356 exchange as compared to the issuance of a similar debt instrument (on which gain could be deferred under the installment method).

Technical Comments on the Administration's Proposed Modification of NOLC Provisions

1. As noted in the Administration's explanation, the purpose of NOLC provisions historically was to "correct for income distortions that result when the end of a taxable year separates income from related losses." A change that significantly separates an event (the loss) from the recognition of that event in the tax law (through loss carryovers) departs from that purpose.

2. From our perspective, the complexity involved in three-year carrybacks has not been a major problem, and does not differ significantly from that involved with a one-year carryback.

3. Changing a net operating loss from a carryback to a carryforward would not only change the timing of the use of that loss, but also may affect the availability of the loss. For example, Section 382 may apply to limit the future use of NOL carryforwards, whereas the use of a carryback would not have been so limited. To take a different example, if (as is not uncommon) a loss corporation is not rehabilitated and does not go forward as a profit-making enterprise, NOL carryforwards will never be used; in such cases the shortening of the carryback period not only means the losses are never used, but also may have the effect of reducing the funds available for creditors.

4. With a reduced carryback, and thus more distortion from the annual accounting system, one would expect taxpayers to resort to "self-help," recognizing built-in-gains and built-in-losses, and deferring or accelerating income or deductions, to lessen the "waste" of otherwise reportable tax losses, or to reduce taxable income for a particular tax year.

Technical Comments on the Administration's Proposal to Repeal Section 1374 for Large Corporations

1. The basic scope of the proposal is not clear. The December 7 Treasury description stated that the proposal would "require the converting corporation to recognize immediately the built-in gain in corporate assets at the time of conversion." The Joint Committee explanation provides, however, that "a C to S corporation conversion . . . would be treated as a liquidation of the C corporation . . . [t]hus the proposal would require immediate gain recognition by both the corporation (with respect to its appreciated assets) and its shareholders (with respect to their stock) . . . ." (The confusion surrounding the interpretation of this proposal exemplifies the flaws in prescribing immediate effective dates.)

2. Repealing Section 1374 would not, in se, result in the treatment of an S election as a taxable corporate liquidation, for Section 1374 simply overrides the general pass-through nature of S corporations by imposing tax on certain built-in gains. To achieve the results described in the December proposals it would be necessary to enact specific provisions treating the conversion as a recognition event for the converting corporation and (per the JCT) the shareholders.

3. The treatment of an S election as a taxable liquidation is inconsistent in certain important respects with the ongoing tax treatment of the S corporation as a corporation. For example, corporate provisions like Sections 291, 311 and 357(c) apply to S corporations. On the other hand, important pass-through provisions like Sections 752 and 754 do not apply to S corporations. Consideration should be given to coordinating the rationale underlying the proposal with the ongoing tax treatment of the S corporation.

4. The proposal is described as applying to "large corporations." This was defined by the Treasury and the JCT as corporations with a value of more than $5 million, with the $5 million test applied by reference to the value of the corporate stock (as compared to corporate assets). We note that a test based on stock value will result in similarly sized businesses being treated differently, depending on whether they are financed by debt or by equity.

5. The $5 million threshold appears to be a cliff, rather than an exemption level. Thus, if a corporation is valued at $5,100,00, all gain is taxable, whereas a corporation valued at $4,900,000 would not be taxed on conversion. This will put particular pressure on the difficult problem of valuing the stock of a closely-held corporation. An alternative would be to exempt gain attributable to up to $5 million of value, somewhat like the operation of Section 453A(c)(4).

6. The JCT describes the proposal as treating the conversion as a liquidation of the C corporation, followed by a contribution of its assets by the recipient shareholders to an S corporation. Consideration should be given to the effects of this constructive liquidation/contribution under other Code provisions, such as Section 1223, Section 1031(f), Section 1231, Section 708, Section 197, etc.

Technical Comments on the Proposed Further Restriction of Section 1031

1. In general, the mobility of personal property presents a number of issues that were not implicated by the 1989 amendments to Section 1031 respecting exchanges of domestic and foreign real property. As discussed below, we believe these problems generally can be addressed without impairing the basic proposal.

2. The proposal classifies property as foreign or domestic based upon its situs "at the time of the exchange." Where personal property is received in an exchange by a taxpayer who surrendered property located in the United States, that taxpayer may have the clear intention of using the replacement property in the United States, but the seller of the replacement property may be unwilling to move that property to, and close in, the United States, whether for fear of adverse United States tax consequences, or for other reasons. Similarly, if a buyer of the surrendered property is unwilling to take title in the United States, the property may be transferred overseas for a brief period prior to closing. Query whether these temporary situations should change the fundamental character of the asset. To address these kinds of situations, the proposal could provide that if property transferred or received in an exchange is not located in the proper locale at the time of disposition or acquisition, but was located in the proper locale within, say, thirty days before the disposition or is moved into the proper locale within thirty days after the acquisition, and otherwise meets the pre- and post-exchange holding period requirements, the requirements of the new proposal would be satisfied.

2. In light of the availability of deferred like-kind exchanges, the location of the surrendered property should be determined at the time of its disposition, and the location of the replacement property should be determined at the time of its acquisition by the taxpayer.

3. The proposal also requires that the exchanged property and the replacement property be used for 24 months before and after the exchange in the proper locale. If this proposal is intended to impose a two-year holding period on exchanged personal property, it would represent a considerable change in the law. For example, if property was first acquired by the taxpayer

within two years before the exchange, or is retired or sold within two years after the exchange, does the proposal mean that the taxpayer could not qualify under Section 1031 even if the exchanged properties otherwise would qualify as used in a trade or business or held for investment? This should be considered and clarified.

Furthermore, consideration should be given to whether incidental use in the other locale (such as for repairs) vitiates reliance on Section 1031. And to accommodate deferred exchanges, the 24-month periods should be measured by reference to the dates of disposition and acquisition, respectively.

4. Although Section 865 of the Code sets forth certain source rules, and the FSC regulations set forth certain rules regarding the foreign location of export property, those rules may not be particularly appropriate for purposes of Section 1031. Consideration should be given to adopting, for purposes of the new like-kind limitation, the standard set forth in Section 168(g)(1) of the Code for determining whether personal property is used predominantly outside the United States. These rules, which are the same as the rules that were used to determine whether property qualified for the investment tax credit, are used to determine whether personal property qualifies for accelerated MACRS depreciation or whether it must be depreciated on a straight-line basis over a longer period (in the case of property used predominantly outside the United States). In addition, Section 168(g)(4) sets forth special rules for property which is considered to be used in the United States even though it is actually located outside the United States more than 50% of the time. For example, United-States registered aircraft used to and from the United States have always received the benefit of domestic depreciation even though they may be physically present outside the United States more than 50% of the time. Section 168(g)(4) similarly provides domestic depreciation treatment for certain railroad rolling stock, vessels, satellites, etc. It would seem consistent with the rationale of Section 168, as well as the goals of the proposed like-kind rule, to incorporate rules along the lines of Section 168(g) in determining the location of exchanged property.

5. When Section 1031(h) was adopted in 1989 to preclude domestic:foreign exchanges of real property, Congress provided transition relief. Thus, while the 1989 amendment generally applied to transfers made after

July 10, 1989, transfers made pursuant to a binding contract in effect on July 10, 1989 were excluded from application of the provision. Similar relief seems appropriate for this proposal, so that taxpayers who had binding commitments for exchanges of property on December 7 would not be subject to the change in the law. Furthermore, given the Section 1031 provisions permitting deferred exchanges, it also seems appropriate to provide transitional relief for taxpayers who entered into binding contracts to dispose of property, or who actually disposed of property, on or before December 7, provided such taxpayers identify their exchange property and complete a deferred exchange within the time periods currently required under Section 1031. Finally, consideration should be given to providing transitional relief for taxpayers who, on or before December 7, had binding commitments to acquire property, if such acquisition is in fact completed as an exchange otherwise qualifying under Section 1031.

December 7, 1995

CORPORATE SUBSIDIES, LOOPHOLE CLOSERS, AND OTHER MEASURES

INDEX

PROPOSAL

* * *

December 7, 1995

REFORM DEPRECIATION UNDER THE INCOME FORECAST METHOD

CURRENT LAW

Pursuant to several administrative pronouncements, the IRS has ruled that the cost of motion picture films, video tapes, sound recordings, and other similar property may be depreciated under the "income forecast" method, pursuant to which depreciation for any taxable year is determined by dividing the income realized for that year by the total estimated income from the property. The IRS has also ruled that the estimated income to be included in the denominator does not include income from television exhibition in the case of motion pictures released for theatrical exhibition, or income from syndication in the case of a television series or movie. In addition, estimated income does not include revenue from the exploitation of film characters. Such property is not eligible for depreciation under the modified accelerated cost recovery system.

REASON FOR CHANGE

While the income forecast method may be an appropriate method for matching income and expenses in certain cases, the exclusion of income from certain sources results in an inappropriate acceleration of depreciation deductions. In addition, the use of estimates in the income forecast method necessarily results in a mismatch between income and depreciation deductions when the estimate of future income is either too high or too low. A look-back method, i.e., a procedure to compensate for errors in estimates in prior taxable years, would eliminate any benefit that taxpayers may obtain from understating the estimated income from property, thereby overstating their depreciation deductions.

PROPOSAL

Several changes to the income forecast method of determining depreciation deductions would be made. All estimated income from the use of the property or the sale of merchandise would be taken into account in the denominator, other than income expected to be generated more than ten taxable years after the year in which the property was placed in service. For purposes of this rule, income realized by the taxpayer from related party transactions would be ignored, but income realized by the related party from the ultimate transaction with unrelated third parties would be taken into account. The basis for depreciation for any taxable year may only include amounts that satisfy the economic performance requirements of section 461(h) as of the end of the year (including the recurring item exception). The adjusted basis remaining at the beginning of the tenth taxable year after the year in which the property is placed in service

may be recovered in full in that year. Finally, a look-back method would be imposed and applied in a manner similar to the long-term contract provisions of section 460 (together with de minimis exceptions). A special rule is provided for an episode in a television series, pursuant to which income from syndication is not required to be taken into account, for purposes of either the income forecast method or the look-back computation, before the earlier of the fourth taxable year after the year in which the first episode is placed in service or the earliest taxable year in which the taxpayer has an arrangement relating to the future syndication of the series. The changes would apply to property placed in service after September 13, 1995, unless subject to a binding contract as of that date.

This proposal is substantially similar to a provision contained in the Revenue Reconciliation Act of 1995 as passed by Congress.

PHASE OUT PREFERENTIAL TAX DEFERRAL FOR CERTAIN LARGE FARM CORPORATIONS REQUIRED TO USE ACCRUAL ACCOUNTING

CURRENT LAW

The Revenue Act of 1987 required certain closely held farm corporations (and partnerships with corporate partners) to change to the accrual method of accounting if their gross receipts exceed $25 million in any taxable year beginning after 1985. However, in lieu of making a section 481(a) adjustment for the year of change, such taxpayers were permitted by section 447(i) to establish a "suspense account" for the lesser of the section 481(a) adjustment for the year of change or the adjustment that would have been applicable for the preceding taxable year. This suspense account is not required to be taken into account unless the corporation ceases to meet the closely held test or except to the extent that the gross receipts of the entity are reduced in any taxable year below the amount applicable to the last year prior to the year of change. As a result, the suspense account provision represents a potentially indefinite deferral of the section 481(a) adjustment.

REASON FOR CHANGE

Section 447(i) is a substantial and inappropriate departure from the policy underlying section 481(a) and the administrative practices of the Service, in which the cumulative adjustments resulting from accounting method changes are taken into account generally over periods not exceeding six years.

PROPOSAL

The proposal would provide that no suspense accounts may be established under section 447(i). Any taxpayer required to change to the accrual method after the effective date would be required to take its section 481 (a) adjustment into account generally over a ten-year period. Any existing suspense accounts must be restored to income ratably over a 20-year period (or sooner to the extent provided by existing law). This provision would be effective for taxable years ending after September 13, 1995.

This proposal is substantially similar to a provision contained in the Revenue Reconciliation Act of 1995 as passed by Congress.

DISALLOW INTEREST DEDUCTION FOR CORPORATE-OWNED LIFE INSURANCE (COLI) POLICY LOANS

CURRENT LAW

No federal income tax generally is imposed on a policyholder with respect to the undistributed earnings under a life insurance contract (inside buildup), provided the life insurance contract meets certain requirements (section 7702). Further, an exclusion from Federal income tax is provided for death benefits received under a life insurance contract (section 101(a)). The policyholder may generally borrow with respect to a life insurance contract (other than a modified endowment contract) without affecting these exclusions.

The present law limits the allowance of a deduction for interest paid or accrued on any borrowings with respect to a life insurance, endowment or annuity contract. These limitations include specific disallowance provisions of section 264 and other statutory and judicial rules which may apply to preclude an interest deduction.

One of the section 264 rules disallows any deduction for interest paid or accrued on indebtedness with respect to one or more life insurance contracts covering the life of any individual who is (1) an officer or employee of, or (2) financially interested in, any trade or business carried on by the taxpayer to the extent that the aggregate amount of the indebtedness with respect to contracts covering the individual exceeds $50,000. This $50,000 limitation was added by the Tax Reform Act of 1986 and applies to contracts purchased after June 20, 1986.

REASON FOR CHANGE

A company that sets up a COLI program typically purchases life insurance contracts on the lives of its employees, in many cases thousands or tens of thousands of employees, including former employees. The company, not the employee's family, receives all or most of the proceeds on the employee's death. The company typically borrows against the cash value of the life insurance contracts at an interest rate just above the rate at which inside buildup is credited under the contract. The interest that the company pays on policy loans is credited under the contract and increases the tax-free inside buildup. If the interest on the policy loans is in fact deductible under present law, the after-tax interest expense is less than the interest income being credited under the policy (the inside build-up). In addition, tax-free death benefits that the company receives on the death of insured employees subsidize the payment of premiums in future years.

Large COLI programs may be viewed as the economic equivalent of a tax-free savings account owned by the company into which it pays itself interest. The taxpayer is indirectly paying interest to itself through an increase in the value of the life insurance contract of which the taxpayer is the beneficiary. A general principle of accurate income measurement provides that expenses such as in-

terest are not deductible if they are costs of accretions of wealth that are not included in income. For example, interest incurred to purchase or carry tax-exempt bonds is not deductible under section 265 of the Code.

COLI programs represent an attempt to inappropriately use the tax rules to achieve a result that was never contemplated by Congress. When the $50,000 limit was enacted in 1986, it was not anticipated that it would lead to the purchase of life insurance products covering hundreds and thousands of employees of a business organization in an attempt to maximize the tax arbitrage of deducting interest that is credited, tax-free, to the organizations that own the insurance contract.

A 1990 Treasury Report to Congress found that the increases in COLI programs since 1986 demonstrate that the Congressional intent was not accomplished and further that "borrowing against corporate owned life insurance does not provide family protection, subverts other Congressional limitations on tax-preferred retirement and health plans, and loses revenue." Department of Treasury, Report to The Congress on The Taxation of Life Insurance Company Products, 3 (March 1990).

PROPOSAL

Section 264 would be amended to provide that no deduction is allowed for interest paid or accrued on any indebtedness with respect to one or more life insurance, endowment or annuity contracts covering any individual who is (1) an officer or employee of, or (2) financially interested in, any trade or business carried on by the taxpayer, regardless of the aggregate amount of debt with respect to policies or contracts covering the individual.

The proposal is not intended to affect the tax treatment of any interest paid or accrued under present law (including whether interest paid or accrued during the phase-in is otherwise deductible), and the IRS would not be precluded from challenging COLI plans under current law.

The provision would be effective generally with respect to interest paid or accrued after December 31, 1995. However, subject to the limitations described below, the provision would be phased in by allowing the taxpayer to deduct 50% of the otherwise deductible interest incurred during 1996 on debt incurred before September 18, 1995, with respect to a life insurance contract that was in effect on that date and that covers only the individual who was insured under the contract on that date. Only interest that would have been deductible but for this proposal is allowed under this phase-in. In addition, no deduction is allowed under this phase-in with respect to interest on borrowings by a taxpayer with respect to contracts on the lives of more than 20,000 insured individuals (for this purpose, all persons treated as a single employer are treated as one taxpayer). Finally, no deduction is allowed to the extent the rate of interest exceeds the lesser of (1) the borrowing rate specified in the contract as of September 18, 1995, or (2) the Moody's Corporate Bond Yield Average - Monthly Average Corporates for each month the interest is paid or accrued.

Any amount included in income during 1996 or 1997 that is received under a contract described in the proposal on the complete surrender, redemption, or maturity of the contract or in full discharge of the obligation under the contract that is in the nature of a refund of the consideration paid for the contract is includible ratably over the first four taxable years beginning with the taxable year the amount would otherwise have been includible.

This proposal is substantially similar to a provision contained in the Revenue Reconciliation Act of 1995 as passed by Congress.

REQUIRE GAIN RECOGNITION FOR CERTAIN EXTRAORDINARY DIVIDENDS

CURRENT LAW

A corporate shareholder is generally allowed to deduct a certain percentage of dividends received from another domestic corporation. A corporate shareholder who receives an "extraordinary" dividend is required to reduce the basis of the stock with respect to which the dividend was received by the non-taxed portion of the dividend (section 1059). Whether a dividend is "extraordinary" is determined by reference to, among other things, the size of the dividend in relation to the adjusted basis of the shareholder's stock. Also, a dividend resulting from a non prorata redemption or partial liquidation is an extraordinary dividend. If the reduction in basis of stock exceeds the basis in the stock with respect to which an extraordinary dividend is received, the excess is taxed as gain at the time of a sale or disposition of such stock.

In general, a distribution in redemption of stock is treated as a dividend, rather than as a sale of the stock, if it is essentially equivalent to a dividend. A redemption of the stock of a shareholder generally is essentially equivalent to a dividend if it does not result in a meaningful reduction in the shareholder's proportionate interest in the distributing corporation. The determination whether a redemption is essentially equivalent to a dividend includes reference to the constructive ownership rules of section 318, including the option attribution rules of section 318(a)(4). The rules relating to treatment of other property received in a reorganization contain a similar reference (section 356(a)(2)).

REASON FOR CHANGE

Some corporate taxpayers are attempting to dispose of stock of other corporations in transactions structured as redemptions, where the redeemed corporate shareholder apparently expects to take the position that the transaction qualifies for the dividends-received deduction. Thus, the redeemed corporate shareholder attempts to exclude from income a substantial portion of the amount received. In some cases, it appears that the taxpayer's interpretations of the option attribution rules of section 318(a)(4) are important to the taxpayers' contentions that their interests in the distributing corporation are not meaningfully reduced.

Also. the present rules may be permitting inappropriate deferral of gain recognition when the portion of the distribution that is excluded due to the dividends-received deduction exceeds the basis of the stock with respect to which the extraordinary dividend is received.

PROPOSAL

The extraordinary dividend rules of section 1059 would be amended to provide that a corporate shareholder will recognize gain immediately with respect to any redemption treated as a dividend (in whole or in part) when the nontaxed portion of the dividend exceeds the basis of the shares surrendered, if the redemption is treated as a dividend due to options being counted as stock ownership. In addition, immediate gain recognition is required whenever the basis of stock with respect to which any extraordinary dividend was received is reduced below zero. Reorganizations or other exchanges involving amounts that are treated as dividends under section 356(a)(2) of the Code are treated as redemptions for purposes of applying the rules relating to redemptions under section 1059(e). The provision is effective generally for distributions after May 3, 1995.

This proposal is substantially similar to a provision contained in the Revenue Reconciliation Act of 1995 as passed by Congress.

MODIFY BASIS ADJUSTMENT RULES UNDER SECTION 1033

CURRENT LAW

Section 1033 provides generally that gain realized from certain involuntary conversions is deferred to the extent the taxpayer purchases property similar or related in service or use to the converted property within a specified period of time. The replacement property may be acquired directly or, alternatively, indirectly by acquiring control of a corporation that owns replacement property. The taxpayer's basis in the replacement property generally is the same as the taxpayer's basis in the converted property, decreased by the amount of money received or loss recognized on the conversion, and increased by the amount of any gain recognized on the conversion. The IRS has taken the position that, if the replacement property is stock in a corporation, the basis adjustment rules do not affect depreciation deductions claimed by the corporation with respect to the assets it owns.

REASON FOR CHANGE

Where the replacement property in an involuntary conversion is stock in a corporation, it is necessary to adjust the basis in the assets of the corporation in order to properly reflect the purpose of the involuntary conversion rollover rules to allow deferral of gain recognition (but not avoidance of that gain).

PROPOSAL

Under the proposal, where a taxpayer acquires a controlling interest in the stock of a corporation as replacement property after an involuntary conversion, the corporation will generally be required to reduce its adjusted bases in its assets by the same amount as the taxpayer is required to reduce its basis in the acquired stock. The corporation's adjusted bases in its assets would not be reduced, in the aggregate, below the taxpayer's basis in its stock. In addition, the basis of any individual asset would not be reduced below zero. The basis reduction would be applied first to property that is similar or related in service or use to the converted property, then to other depreciable property, and finally to any other property. This proposal would be effective for involuntary conversions occurring after September 13, 1995.

This proposal is substantially similar to a provision contained in the Revenue Reconciliation Act of 1995 as passed by Congress.

REQUIRE REGISTRATION OF CERTAIN CONFIDENTIAL CORPORATE TAX SHELTERS

CURRENT LAW

A tax-shelter organizer must register the shelter with the IRS if the tax shelter meets the following two requirements. First, any investment in the tax shelter must be (1) pursuant to an offering that is required to be registered under a Federal or state law regulating securities, (2) pursuant to an offering that is exempt from registration under such laws but with respect to which a notice must be filed with a Federal or state agency regulating the offering or sale of securities, or (3) a substantial investment. Second, any person must be able reasonably to infer from the representations made or to be made in connection with the offering for sale of interests in the investment that the ratio of deductions and 350% of credits to the investment for any investor (the "tax shelter ratio") may be greater than two to one as of the close of any of the first five years ending after the date on which the investment is offered for sale.

REASON FOR CHANGE

Many corporate tax shelters are not registered with the IRS. Requiring registration of corporate tax shelters would result in the IRS receiving useful information at an early date regarding various forms of tax shelter transactions engaged in by corporate participants. This will allow the IRS to make better informed judgments regarding the audit of corporate tax returns and to monitor whether legislation or administrative action is necessary regarding the type of transactions being registered.

PROPOSAL

The proposal would require registration with the IRS of any investment, plan, arrangement or transaction (1) a significant purpose of the structure of which is tax avoidance or evasion by a corporate participant, (2) that is offered to any potential participant under conditions of confidentiality (for example confidentiality agreements entered with or for the benefit of the promoter), and (3) for which the tax shelter promoter (or promoters) may receive total fees in excess of $100,000. Registration materials will be protected taxpayer information, and there will be substantial penalties for non-compliance. The provision is effective for any tax shelter offered to potential participants after the date the Secretary of the Treasury prescribes guidance regarding the filing requirements.

This proposal is substantially similar to a provision contained in the Revenue Reconciliation Act of 1995 as passed by Congress.

REQUIRE THRIFTS TO ACCOUNT FOR BAD DEBTS IN THE SAME MANNER AS BANKS

CURRENT LAW

A thrift institution that holds at least 60 percent of its portfolio in home mortgages (and certain similar loans), cash, and government obligations is permitted to maintain a reserve for bad debts under section 593 of the Internal Revenue Code. Under section 593, a thrift institution generally may calculate the annual addition to its bad debt reserve under either the "percentage of taxable income" method or the "experience" method. Under the percentage of taxable income method, a thrift may deduct 8 percent of its taxable income (determined without regard to the deduction and with certain other adjustments) as an addition to its bad debt reserve. Under the experience method, a thrift may deduct the greater of (1) the percentage of its loans outstanding equal to its average bad debt experience (i.e., bad debt losses as a percentage of loans outstanding) in the current and five preceding years, or (2) the amount necessary to restore its reserve to its balance at the close of the last taxable year beginning before 1988 (adjusted downward to reflect any post-1987 decline in loans outstanding).

The reserve methods of section 593 are more generous than the rules applicable to commercial banks. Under section 585 of the Code, small banks are permitted to use the experience method, but not the percentage of taxable income method. If the adjusted basis of a bank's assets exceeds $500 million, section 585 does not apply and only the specific charge-off method can be used to compute the bad debt deduction.

Under current law, a thrift that loses its eligibility to compute reserves under section 593 because it changes its charter to become a bank or because it fails the 60-percent test described above must account for bad debts as if it were a bank,. In addition, it must recapture, through a section 481(a) adjustment, the amount by which the reserve computed under section 593 exceeds the reserve (if any) computed under section 585. In general, the amount recaptured is included in income ratably over a 6-year period. A thrift that becomes a large bank, however, may use the rules that apply when a small bank becomes a large bank to recapture an amount equal to its reserve computed under the experience method.

REASON FOR CHANGE

As a result of the increasing convergence of the banking and thrift industries, the special rules applicable to thrifts, such as the subsidy provided through the reduction in effective marginal tax rates for thrifts using the percentage-of-taxable-income method, are no longer warranted. Some relief from recapture is appropriate, however, because deferred tax liabilities have not been recorded with respect to pre-1988 additions to thrift bad debt reserves. To require recapture with respect to these amounts, even on a deferred basis. would have a significant effect on the capital of some thrifts. In addition, it is appropriate to provide some incentive for thrifts to continue in the mortgage lending business for a transitional period.

PROPOSAL

Section 593 would be repealed. (In addition, other provisions that apply only to thrift institutions to which section 593 applies (e.g., sections 595 and 596) would also be repealed.) Small thrifts (those with no more than $500 million of adjusted bases in their assets) would be permitted to use either the experience method of section 585 or the specific charge-off method. Large thrifts would be required to use the specific charge-off method. The percentage-of-taxable-income method of computing bad debt reserves would no longer be available.

Any change in the method a thrift uses to compute reserves for bad debts would be treated as a change in method of accounting, and the section 481(a) adjustment with respect to the change generally would be taken into account ratably (recaptured) over a 6-year period beginning with the year of change. However, the balance of the bad debt reserve as of the close of the last taxable year beginning before 1988 would not be recaptured. In the case of a thrift that becomes a small bank, the opening balance of its bad debt reserve for its first taxable year beginning after December 31, 1995, would be the greater of its pre-1988 balance or its reserve computed under the experience method at the close of its last taxable year beginning before January 1, 1996. The pre-1988 balance included in the thrift's bad debt reserve under this rule would not be recaptured (or taken into account in applying the cut-off method) if the thrift later becomes a large bank.

Section 593(e) of current law, (requiring recapture in the case of certain excess distributions to shareholders) would continue to apply to the pre-1988 balance, and the pre-1988 balance would be treated as a tax attribute to which section 381 applies. In addition, the pre-1988 balance would be recaptured if the taxpayer ceases to be a bank (for this purpose, the taxpayer ceases to be a bank if it becomes a credit union).

Recapture of reserves in excess of the pre-1988 balance would be suspended for taxable years beginning in 1996 and 1997 if the taxpayer meets a residential loan requirement. The residential loan requirement is met for a taxable year if the principal amount of residential loans made by the taxpayer during the year is not less than the average of the principal amount of such loans during the six most recent taxable years beginning before 1996. At the election of the taxpayer, the average may be computed by disregarding the high and low years in the six-year period. A residential loan is any loan described in section 7701(a)(19)(C)(v) (generally, loans secured by residential real property, real property used by churches, and mobile homes), but only to the extent the loan is made to acquire, construct, or improve the property. The test would be applied on a controlled group basis.

Any reserve balance that would qualify for recapture suspension if the taxpayer satisfies the residential loan requirement would be treated as a tax attribute to which section 381 applies. In addition, regulations would provide rules for the application of the residential loan requirement in the case of acquisitions, mergers, spin-offs, and other reorganizations.

The proposal would be effective for taxable years beginning after December 31, 1995.

This proposal is substantially similar to a provision contained in the Revenue Reconciliation Act of 1995 as passed by Congress.

EXTEND OIL SPILL LIABILITY TRUST FUND EXCISE TAX

CURRENT LAW

Before January 1, 1995, a five-cents-per-barrel excise tax was imposed on domestic crude oil and imported petroleum products. The tax was dedicated to the Oil Spill Liability Trust Fund to finance the cleanup of oil spills and was not imposed for a calendar quarter if the unobligated balance in the Trust Fund exceeded $1 billion at the close of the preceding quarter.

REASON FOR CHANGE

Reimposition of the Oil Spill Liability Trust Fund will ensure that funds will continue to be available for the cleanup of oil spills.

PROPOSAL

The proposal would reinstate the Oil Spill Liability Trust Fund excise tax for the period beginning on January 1, 1996, and ending on September 30, 2002. As under current law, the tax would be suspended if the $1 billion limit on unobligated Trust Fund balances is exceeded.

This proposal is substantially similar to a provision contained in the Revenue Reconciliation Act of 1995 as passed by Congress.

REPEAL PERCENTAGE DEPLETION FOR NON-FUEL MINERALS MINED ON FEDERAL LANDS

CURRENT LAW

Taxpayers are allowed to deduct a reasonable allowance for depletion relating to the acquisition and certain related costs of mines or other hard mineral deposits. The depletion deduction for any taxable year is calculated under either the cost depletion method or the percentage depletion method, whichever results in the greater allowance for depletion for the year.

Under the cost depletion method, the taxpayer deducts that portion of the adjusted basis of the property which is equal to the ratio of the units sold from that property during the taxable year, to the estimated total units remaining at the beginning of that year.

Under the percentage depletion method, a deduction is allowed in each taxable year for a statutory percentage of the taxpayer's gross income from the property. The percentage depletion deduction for these minerals may not exceed 50 percent of the net income from the property for the taxable year (computed without allowance for depletion). Percentage depletion is not limited to the taxpayer's basis in the property; thus, the aggregate amount of percentage depletion deductions claimed may exceed the amount expended by the taxpayer to acquire and develop the property.

An 1872 mining act has allowed investors to acquire mining rights on Federal lands at the cost of $5.00 per acre or less.

REASON FOR CHANGE

The percentage depletion provisions under present law generally are viewed as an incentive for mineral production rather than as a normative rule for recovering the taxpayer's investment in the property. This incentive, however, is excessive with respect to minerals mined on Federal lands under the 1872 mining act, in light of the minimal costs of acquiring these mining rights. In addition, the measurement of income in the affected industries will be improved by the repeal of these percentage depletion provisions.

PROPOSAL

The proposal would repeal percentage depletion provisions under present law for non-fuel minerals mined on Federal lands where the mining rights were originally acquired through the patent process in the 1872 law. The proposal would be effective for taxable years beginning after December 31, 1995.

DENY INTEREST DEDUCTION ON CERTAIN DEBT INSTRUMENTS

CURRENT LAW

Whether an instrument qualifies for tax purposes as debt or equity is determined under all the facts and circumstances based on principles developed in case law. If an instrument qualifies as equity, the issuer generally does not receive a deduction for dividends paid. If an instrument qualifies as debt, the issuer may receive a deduction for accrued interest and the holder generally includes interest in income, subject to certain limitations.

Original issue discount ("OID") on a debt instrument is the excess of the stated redemption price at maturity over the issue price of the instrument. An issuer of a debt instrument with OID generally accrues and deducts the discount as interest over the life of the instrument even though interest may not be paid until the instrument matures. The holder of such a debt instrument also generally includes the OID in income on an accrual basis.

Section 385(c) provides rules for when an issuer's characterization of an interest in a corporation shall be binding on the issuer and the holders.

REASON FOR CHANGE

The line between debt and equity is uncertain, and it has proven difficult to formulate general rules to classify an instrument as debt or equity for all purposes or to bifurcate an instrument into its debt and equity components. While the IRS has taken the position that some purportedly debt instruments with substantial equity features should be treated as equity, other instruments have not been specifically addressed. Taxpayers have exploited this lack of guidance by, among other things, issuing instruments that have substantial equity features (including many non-tax benefits of equity), but as to which they

claim interest deductions. In many cases, these instruments have been issued in exchange for outstanding preferred stock.

PROPOSAL

Under the proposal no deduction would be allowed for interest or OID on an instrument (other than a demand loan) issued by a corporation (or issued by a partnership to the extent of its corporate partners) that (i) has a maximum term of more than 40 years, or (ii) is payable in stock of the issuer or a related party (within the meaning of sections 267(b) and 707(b)), including an instrument that is mandatorily convertible or convertible at the issuer's option. In addition, an instrument would be treated as payable in stock of the issuer or a related party if it is part of an arrangement designed to result in the payment of debt with such stock, such as certain issuances of a forward contract in connection with the issuance of debt, nonrecourse debt that is secured principally by such stock, or certain debt instruments that are convertible at the holder's option when it is substantially certain that the right will be exercised. Thus, the proposal would not affect typical convertible debt.

The proposal would also clarify that for purposes of section 385(c), an issuer will be treated as having characterized an instrument as equity if the instrument (other than a demand loan) (i) has a maximum term of more than 20 years, and (ii) is not shown as indebtedness on the separate balance sheet of the issuer. For this purpose, in the case of an instrument issued to a related party (other than a corporation) that is eliminated in the consolidated balance sheet that includes the issuer and holder, the issuer will be treated as having characterized the instrument as equity if the holder issues a related instrument that is not shown as indebtedness on the consolidated balance sheet. For this purpose, an instrument would not be treated as shown as indebtedness on a balance sheet because it is described as such in footnotes or other narrative disclosures. The proposal would apply only to corporations that file annual financial statements with the Securities and Exchange Commission (SEC), and the relevant balance sheet is the balance sheet filed with the SEC.

The proposal is not intended to affect the tax characterization of instruments described in this proposal as debt or equity under current law.

The proposal would be effective for instruments issued on or after the date of announcement.

DEFER ORIGINAL ISSUE DISCOUNT DEDUCTION ON CONVERTIBLE DEBT

CURRENT LAW

If a financial instrument qualifies as debt, the issuer of the instrument may receive a deduction for accrued interest and the holder generally includes interest in income. Original issue discount ("OID") is the excess of the stated redemption price at maturity over the issue price of a debt instrument. An issuer of a debt instrument with OID generally accrues and deducts the discount as interest over the life of the instrument even though interest may not be paid until the instrument matures. The holder of such a debt instrument also generally includes the OID in income on an accrual basis.

If a debt obligation is convertible into stock and provides no payment of, or adjustment for, accrued interest on conversion, no deduction is allowed for accrued but unpaid stated interest.

In contrast to the rules that apply to convertible debt instruments with stated interest, accrued but unpaid discount on a convertible debt instrument with OID generally is deductible, even if the instrument is converted before the issuer pays any OID.

REASON FOR CHANGE

In many cases, the issuance of convertible debt with OID is viewed by market participants as a de facto purchase of equity.

PROPOSAL

The proposal would defer the deduction for OID on convertible debt until payment. Conversion would not be treated as a payment of accrued OID. Payment in equity of the issuer or a related person (within the meaning of sections 267(b) and 707(b)) would also be disregarded for this purpose. For purposes of this proposal, convertible debt would include debt (i) exchangeable for the stock of a party related to the issuer, (ii) with cash-settlement conversion features, or (iii) issued with warrants (or similar instruments) as part of an investment unit in which the debt instrument may be used to satisfy the exercise price for the warrant. The proposal would not affect the treatment of holders. The proposal would be effective for convertible debt issued on or after the date of announcement.

REDUCE DIVIDENDS-RECEIVED DEDUCTION TO 50 PERCENT

CURRENT LAW

If an instrument issued by a U.S. corporation is classified for tax purposes as equity, a corporate holder of that instrument generally is entitled to a deduction for dividends received on that instrument. This deduction is 70 percent of dividends received if the recipient owns less than 20 percent (by vote and value) of the stock of the payor. If the recipient owns more than 20 percent of the stock the deduction is increased to 80 percent. If the recipient owns more than 80 percent of the payor's stock, the deduction is further increased to 100 percent for qualifying dividends.

REASON FOR CHANGE

The 70-percent dividends-received deduction is too generous for corporations that cannot be considered an alter ego of the distributing corporation because they do not have a sufficient ownership interest in that corporation.

PROPOSAL

Under the proposal, the dividends-received deduction available to corporations owning less than 20 percent (by vote and value) of the stock of a U.S. corporation would

be reduced to 50 percent of the dividends received. The proposal would be effective for dividends paid after January 31, 1996.

MODIFY HOLDING PERIOD FOR DIVIDENDS-RECEIVED DEDUCTION

CURRENT LAW

If an instrument issued by a U.S. corporation is classified for tax purposes as equity, a corporate holder of that instrument generally is entitled to a deduction for dividends received on that instrument. This deduction is 70 percent of dividends received if the recipient owns less than 20 percent (by vote and value) of the stock of the payor. If the recipient owns more than 20 percent of the stock the deduction is increased to 80 percent. If the recipient owns more than 80 percent of the payor's stock, the deduction is further increased to 100 percent for qualifying dividends.

The dividends-received deduction is allowed to a corporate shareholder only if the shareholder satisfies a 46-day holding period for the dividend-paying stock (or a 91-day period for certain dividends on preferred stock). The 46- or 91-day holding period generally does not include any time in which the shareholder is protected from the risk of loss otherwise inherent in the ownership of an equity interest.

REASON FOR CHANGE

No deduction for a distribution on stock should be allowed when the owner of stock does not bear the risk of loss otherwise inherent in the ownership of an equity interest at a time proximate to the time the distribution is made.

PROPOSAL

The proposal would provide that a taxpayer is not entitled to a dividends-received deduction if the taxpayer's holding period for the dividend-paying stock is not satisfied over a period immediately before or immediately after the taxpayer becomes entitled to receive the dividend. The proposal would be effective for dividends paid after January 31, 1996.

TREAT CERTAIN PREFERRED STOCK AS "BOOT"

CURRENT LAW

In reorganization transactions within the meaning of section 368, no gain or loss is recognized except to the extent "other property" is received, that is, property other than certain stock, including preferred stock. Thus, preferred stock can be received tax-free in a reorganization, notwithstanding that many preferred stocks are functionally equivalent to debt securities. Upon the receipt of other property, gain but not loss can be recognized. A special rule permits debt securities to be received tax-free, but only to the extent debt securities of no lesser principal amount are surrendered in the exchange. Other than this debt-for-debt rule, similar rules generally apply to transactions described in section 351.

REASON FOR CHANGE

Tax-free treatment in a reorganization or section 351 transaction is inappropriate for preferred stock that has an enhanced likelihood of recovery of principal or of maintaining a dividend or both, or that otherwise has certain non-stock characteristics.

PROPOSAL

The proposal would amend both sections 351 and 356 (which applies in the case of reorganizations under section 368) to treat certain preferred stock as "other property" (boot), subject to certain exceptions. Thus, when a taxpayer exchanges property for this preferred stock in a transaction that qualifies under either section 351 or section 368, gain but not loss would be recognized.

The proposal would apply to preferred stock (i.e., stock that is limited and preferred as to dividends and does not participate in corporate growth to any significant extent, including through a conversion privilege), where (i) the holder has the right to put the stock to the issuer or a related party (within the meaning of sections 267(b) and 707(b)), (ii) the stock is subject to mandatory redemption by the issuer or a related party, (iii) the issuer (or a related party) has the right to call the stock and, as of the issue date, it is more likely than not that the right will be exercised, or (iv) the dividend rate varies in whole or in part directly or indirectly with reference to interest rates, commodity prices, or other similar indices, regardless of whether such varying rate is provided as an express term of the stock (for example, in the case of an adjustable rate stock) or as a practical result of other aspects of the stock (for example, in the case of auction rate stock). For this purpose, clauses (i), (ii) and (iii) are not satisfied if the put or call cannot be exercised, or the redemption cannot occur, within 20 years of the date the instrument is issued.

The following exchanges would be excluded from this gain recognition: (1) an exchange of preferred stock for comparable preferred stock of the same or lesser value; (2) an exchange of preferred stock for common stock; (3) an exchange of debt securities for preferred stock of the same or lesser value as the adjusted issue price of the debt; and (4) exchanges of stock in certain recapitalizations of family-owned corporations. For this purpose, a family-owned corporation would be defined as any corporation if at least 50 percent of the total voting power and value of the stock of such corporation is owned by members of the same family for five years preceding the recapitalization. In addition, a recapitalization does not qualify for the exception if the same family does not own 50 percent of the total voting power and value of the stock throughout the three-year period following the recapitalization. Members of the same family would be defined by reference to the definition in section 447(e). Thus, a family would include children, parents, brothers, sisters, and spouses, with limited attribution for directly and indirectly owned stock of the corporation. Shares held by a family member would be treated as not held by a family member to the extent a non-family member had a right, option or agreement to acquire the shares (directly or indirectly, for example, through redemptions by the issuer), or with respect to shares as to which a family

member has reduced its risk of loss with respect to the share, for example, through an equity swap. Even though the provision excepts certain family recapitalizations, the special valuation rules of section 2701 for estate and gift tax consequences still apply.

The Treasury Secretary would have regulatory authority to (i) apply installment-sale type rules to preferred stock that is subject to this proposal in appropriate cases, and (ii) prescribe treatment of preferred stock subject to this provision under other provisions of the Code (e.g., sections 304, 306 and 318).

The proposal would be effective for transactions on or after the date of announcement.

EXTEND PRO RATA DISALLOWANCE OF TAX-EXEMPT INTEREST EXPENSE TO ALL CORPORATIONS

CURRENT LAW

No income tax deduction is allowed for interest on debt used directly or indirectly to acquire or hold investments the income on which is tax-exempt. The determination of whether debt is used to acquire or hold tax-exempt investments differs depending on the holder of the instrument. For financial institutions and dealers in tax-exempt investments, debt generally is treated as financing all of the taxpayer's assets proportionately. For corporations, other than financial institutions and dealers, and for individuals, however, a tracing rule is employed. Under this approach, deductions are disallowed only when indebtedness is incurred or continued for the purpose of purchasing or carrying tax-exempt investments. One court has applied the tracing rule across members of the same consolidated group, but no general related-party rule applies.

REASON FOR CHANGE

The current rules applicable to corporations other than financial institutions and dealers in tax-exempt investments permit those corporations to reduce their tax liabilities inappropriately through double Federal tax benefits of interest expense deductions and tax-exempt interest income. The treatment of financial institutions and dealers therefore should be applicable to all corporations, without regard to the type of business activity the corporation conducts. This approach recognizes that money is fungible, and that, therefore, borrowing for one purpose frees the taxpayer's remaining assets for other purposes.

PROPOSAL

Under the proposal, all corporations would be treated the same as financial institutions are treated under current law (without regard to the small issuer exception of section 265(b)(3)). Thus, corporations investing in tax-exempt obligations would be disallowed deductions for a portion of their interest expense equal to the portion of their total assets that is comprised of tax-exempt investments. The rule would not apply to certain nonsalable tax-exempt bonds acquired by a corporation in the ordinance, course of business in payment for goods or services sold to a State or local government.

In addition, the proposal would apply section 265 to all related parties within the meaning of section 267(f). For members of the same consolidated group, the pro rata rule would apply as if the group were a single entity. For related parties that are not members of the same consolidated group, the current tracing rules would apply, treating all the related parties as a single entity for purposes of this tracing rule. The proposal is not intended to affect the application of section 265 to related parties under current law.

The proposal would be effective for taxable years beginning after December 31, 1995 for obligations acquired after the date of announcement.

REPEAL SECTION 1374 FOR LARGE CORPORATIONS

CURRENT LAW

C corporations are generally subject to a two-tier tax. A corporation can avoid this two-tier tax by electing to be treated as an S corporation or by converting to a partnership. Converting to a partnership is a taxable event that generally requires the corporation to recognize any built-in gain on its assets. The conversion of a C corporation to an S corporation, however, is generally tax-free, except that the S corporation must recognize the built-in gain on assets held at the time of conversion if the assets are sold within 10 years under section 1374.

REASON FOR CHANGE

The tax treatment of the conversion of a C corporation to an S corporation generally should be consistent with the treatment of its conversion to a partnership. In particular, any appreciation in corporate assets that occurred during the time the corporation is a C corporation should be subject to the corporate-level tax.

PROPOSAL

The proposal would repeal section 1374 for corporations with a value of more than $5 million at the time of conversion and require the converting corporation to recognize immediately the built-in gain in corporate assets at the time of conversion. For this purpose, the value of the corporation is the fair market value of all of the stock of the corporation on the date of the conversion to an S corporation. The effect of the proposal would be to recognize the built-in gain of converting corporations with a value of more than $5 million. The proposal would be effective for conversions on or after the date of announcement.

REPEAL LOWER OF COST OR MARKET INVENTORY ACCOUNTING METHOD

CURRENT LAW

Taxpayers required to maintain inventories are permitted to use a variety of methods to determine the cost of their ending inventories, including the last-in, first-out ("LIFO") method, the first-in, first-out ("FIFO") method, and the retail method. Taxpayers not using a LIFO method may determine the carrying values of their inven-

tories by applying the lower of cost or market ("LCM") method and by writing down the cost of goods that are unsalable at normal prices or unusable in the normal way because of damage, imperfection or other causes (the "subnormal goods" method).

REASON FOR CHANGE

The allowance of write-downs under the LCM and subnormal goods methods is an inappropriate exception from the realization principle and is essentially a one-way mark-to-market method that understates taxable income.

PROPOSAL

The proposal would repeal the LCM and subnormal goods methods, effective for taxable years beginning after December 31, 1995. Appropriate wash-sale rules will also be included in the proposal. The proposal would be treated as a change in the method of accounting for inventories, and any resulting section 481(a) adjustment would be included in income ratably over a four-year period beginning with the year of change. These changes would not apply to taxpayers with average annual gross receipts over a three-year period of $5 million or less, with appropriate aggregation rules.

REPEAL COMPONENTS OF COST INVENTORY ACCOUNTING METHOD

CURRENT LAW

Taxpayers required to maintain inventories are permitted to use a variety of methods to determine the cost of their ending inventories, including the last-in, first-out ("LIFO") method, the first-in, first-out ("FIFO") method, and the retail method. Under the regulations, a variety of dollar-value LIFO methods may be used, including double extension, link-chain and other index methods, in order to determine whether an increment has occurred and the cost of that increment. Certain taxpayers are permitted to use simplified LIFO methods based on externally developed price indexes. Some LIFO taxpayers that use a dollar-value, double-extension method make their computations with respect to the three components of cost (materials, labor and overhead) of their finished goods and work-in-process inventories (the "COC" method) rather than the aggregate cost of these goods (the "total product cost" method).

REASON FOR CHANGE

The COC method, in many cases, does not adequately account for technological efficiencies in which skilled labor is substituted for less-skilled labor or where overhead costs (such as factory automation) replace direct labor costs. The costs of inventories determined by using the total product cost method generally are not affected by such factors.

PROPOSAL

The proposal would repeal the COC method, effective for taxable years beginning after December 31, 1995. The repeal of the COC method would be applied on a prospective, or cut-off, basis. Thus, no section 481(a) adjustments would be necessary.

The proposal is not intended to affect the determination of whether the COC method is an appropriate method and the IRS would not be precluded from challenging its use.

REQUIRE REPORTING OF PAYMENTS TO CORPORATIONS RENDERING SERVICES TO FEDERAL AGENCIES

CURRENT LAW

All persons engaged in a trade or business and making payments of $600 or more to another person in remuneration for services generally must report those payments to the IRS and to the recipient. No reporting is required if the recipient is a corporation.

REASON FOR CHANGE

The lack of reporting of payments made to corporations permits significant amounts of income to escape the tax system. We should ensure that corporations that do business with the Federal Government appropriately report as income their payments from the Federal Government.

PROPOSAL

The proposal would generally require reporting of payments of $600 or more made to corporations for services rendered to Federal executive agencies. However, the Treasury Secretary would be authorized to prescribe regulations to except reporting in appropriate circumstances. The proposal would be effective for returns the due date for which (without regard to extensions) is more than 90 days after the date of enactment of the proposal.

INCREASE PENALTIES FOR FAILURE TO FILE CORRECT INFORMATION RETURNS

CURRENT LAW

Any person required to report payments of $600 or more for services that fails to report those amounts timely or reports amounts incorrectly is subject to penalties. The amount of the penalty is generally $50 per for each return with respect to which a penalty is incurred, not to exceed $250,000 during any calendar year. If any failure or error is corrected within 30 days after the required filing date, the penalty imposed is $15 per return, not to exceed $75,000. Failures corrected more than 30 days after the required filing date but before August 1 are subject to a $30 per return penalty, not to exceed $150,000 in any calendar year.

REASON FOR CHANGE

For taxpayers filing large volumes of information returns or reporting significant payments, the general penalty provisions may not be sufficient to encourage timely and accurate reporting. By basing the penalty amount on either the number or amounts, the proposal encourages taxpayers to assure both the accuracy and timeliness of information on each return and in the aggregate.

PROPOSAL

The proposal would increase the general penalty amount for any failure to the greater of $50 per return or 5 percent of the total amount required to be reported. The increased penalty would not apply if the total amount actually reported was at least 97 percent of the amount required to be reported. The proposal would be effective for returns the due date for which (without regard to extensions) is more than 90 days after the date of enactment of the proposal.

FURTHER RESTRICT LIKE-KIND EXCHANGES INVOLVING PERSONAL PROPERTY

CURRENT LAW

An exchange of property, like a sale, is generally a taxable transaction. However, under section 1031 of the Internal Revenue Code, no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged for property of a "like kind" which is to be held for productive use in a trade or business or for investment. In general, any kind of real estate is treated as of a like kind with other real property. By contrast, different kinds of personal property are not treated as of a like kind. Regulations under section 1031 provide that property that is of a "like class" is treated as being of a like kind. Certain types of personal property, such as inventory, stocks and bonds, and partnership interests, are not eligible for nonrecognition treatment under section 1031. In addition, in 1989 Congress amended section 1031 to provide that real property located in the United States and real property located outside the United States are not of a like kind.

In order to preserve the gain not recognized in a like-kind exchange, the basis of the property acquired is equal to the basis of the property transferred, decreased in the amount of any money received by the taxpayer and increased in the amount of gain (or decreased in the amount of loss) recognized by the taxpayer on the exchange.

REASON FOR CHANGE

The limitations on exchanges of personal property should conform to the limitations on exchanges of real property.

PROPOSAL

Under the proposal, personal property located in the United States and personal property located outside the United States would not be treated as like kind. For purposes of this rule, the location of the property surrendered and the property received is determined at the time of the exchange. In addition, the property surrendered in the exchange must have been used during the 24 months immediately prior to the exchange in predominantly the same use (i.e., domestic or foreign) as at the time of the exchange. Furthermore, section 1031 would not apply if the acquired property does not continue in that use at any time during the 24 months immediately following the exchange.

The proposal would be effective for exchanges on or after the date of announcement.

MODIFY LOSS CARRY-BACK AND CARRY-FORWARD RULES

CURRENT LAW

Net operating losses ("NOLs") generally can be used to offset taxable income from the prior three taxable years ("carry-backs") and the succeeding 15 taxable years ("carry-forwards").

REASON FOR CHANGE

NOL carry-backs and carry-forwards may correct for income distortions that result when the end of a taxable year separates income from related losses. However, because of the increased complexity and administrative burden associated with carry-backs, the period of carry-back should be shortened. On the other hand, the carry-forward period under current law can be lengthened to allow taxpayers more time to utilize their NOLs without increasing either complexity or administrative burdens.

PROPOSAL

The proposal would limit carry-backs of NOLs to one year and extend carry-forwards to 20 years. The proposal would be effective for NOLs arising in taxable years beginning after December 31, 1995.

IMPOSE EXCISE TAXES ON KEROSENE AS DIESEL FUEL

CURRENT LAW

A 24.4-cents-per-gallon excise tax is imposed on diesel fuel upon removal from a registered terminal facility unless the fuel is indelibly dyed and is destined for a nontaxable use. Treasury regulations provide that kerosene is not treated as diesel fuel for this purpose. Thus, undyed kerosene is not subject to the diesel fuel excise tax when it is removed from a terminal.

Kerosene is a petroleum distillate that is frequently blended with diesel fuel during cold weather in order to prevent formation of wax crystals in fuel lines. In some parts of the country, diesel fuel/kerosene blends containing 30-percent kerosene are common. When kerosene is blended with previously taxed diesel fuel for highway use, the untaxed portion of the mixture is taxable when the mixture is removed or sold by the blender. If kerosene is mixed with dyed diesel fuel for a nontaxable use, the dye concentration of the mixture must be adjusted to ensure that it meets regulatory requirements for untaxed, dyed diesel fuel.

Kerosene is also used as jet fuel in aircraft engines. Noncommercial aviation fuel is taxed at a rate of 21.9 cents per gallon and commercial aviation fuel is taxed at a rate of 4.4 cents per gallon. Aviation fuel is taxed when it is sold or used by a producer, which is defined to include registered refiners, compounders, blenders, wholesale distributors, and dealers selling aviation fuel solely to other producers. However, sales between these persons

are not taxed. Thus, tax is generally imposed when the fuel is sold to a retail dealer or used by a commercial airline that is registered as a producer.

Clear, low-sulfur kerosene (1-K) may also be used in space heaters, and is often available for this purpose at service station pumps. Kerosene used in space heaters is not subject to a Federal excise tax.

REASON FOR CHANGE

Some wholesale distributors of diesel fuel have suggested that their competitors have not been paying the tax on kerosene that they blend with diesel fuel for highway use. As a result, the government is losing tax revenues and complying taxpayers are at a competitive disadvantage. Although the current treatment of kerosene perpetuates the problems the dyeing requirement was intended to correct, any change to the current system should accommodate uses for which clear kerosene is necessary to comply with Federal or State rules or product safety certifications, and should not impose increased burdens on those who use kerosene in space heaters.

PROPOSAL

Under the proposal, a removal of kerosene from a terminal would be treated as a removal of diesel fuel unless the kerosene qualifies as aviation fuel. Kerosene would qualify as aviation fuel only if the person removing the kerosene establishes, in accordance with Treasury regulations, that the kerosene will be used as aviation fuel. Thus, kerosene other than aviation fuel will be taxed when it is removed from a registered terminal unless it is indelibly dyed and is destined for a nontaxable use. Current law rules would continue to apply to kerosene that qualifies as aviation fuel. In addition, to accommodate State safety regulations that require the use of clear (1-K) kerosene in certain space heaters, a new refund procedure would be provided under which registered ultimate vendors could claim refunds of the tax paid on kerosene sold for that use.

The changes would be effective on April 1, 1996, with appropriate floor stocks taxes imposed on kerosene held on that date.

EXPAND SUBPART F PROVISIONS REGARDING INCOME FROM NOTIONAL PRINCIPAL CONTRACTS AND STOCK LENDING TRANSACTIONS

CURRENT LAW

Subpart F income includes, in various subcategories, income from notional principal contracts referenced to foreign currency, commodities, or interest rates, or to indices based thereon. It also includes income with respect to the lending of debt securities. Subpart F income does not include income from equity swaps or other types of notional principal contracts or income from transfers of equities subject to section 1058. Subpart F provides piecemeal exceptions for dealers in foreign currency, commodities, inventory, or certain other property. However, it does not provide an exception for dealers in financial instruments referenced to commodities.

REASON FOR CHANGE

Subpart F income should include income from all types of notional principal contracts and from stock-lending transactions, subject to a limited dealer exception. Such income is indistinguishable on policy grounds from other types of highly mobile income already targeted by subpart F.

PROPOSAL

The proposal would amend section 954 to create a new category of subpart F income -- income from notional principal contracts -- and to include in subpart F income the income with respect to the transfer of equities subject to section 1058. This would have the effect of including in subpart F income the net income from equity swaps and certain categories of notional principal contracts that are not reached by current law, as well as income from stock lending transactions.

Any income, gain, deduction, or loss from a notional principal contract entered into to hedge an item of income in a category of foreign personal holding company income would be included in that category.

In addition, section 954 would be amended to provide an ordinary-course-of-business exception for regular dealers in forwards, options, notional principal contracts, and similar financial instruments (including instruments referenced to commodities).

The proposal would be effective for taxable years beginning after December 31, 1995.

PROVIDE RULES REGARDING TREATMENT OF CAPTIVE "INSURANCE" ARRANGEMENTS

CURRENT LAW

The Code does not define the term "insurance." Case law has long defined the term to require "risk shifting" and "risk distribution." In the case of a controlled foreign corporation ("CFC") that provides insurance to its U.S. shareholders, known as a "captive" insurance company, recent court decisions have held that the risk-shifting and risk-distribution requirements are satisfied even if the captive's unrelated business accounts for just over 30 percent of its total business and that brother-sister subsidiaries are unrelated for this purpose. However, standards applied by the courts have varied considerably from case to case.

Section 953(c) contains special provisions regarding the inclusion of "related person insurance income" in subpart F income. If the CFC is at least 20 percent owned by persons that it insures or persons related to those insureds, all U.S. persons owning any stock of the CFC are treated as United States shareholders of the CFC. In addition, for captives deriving more than 75 percent of their gross premium income from related-person business, the aggregate United States shareholder ownership threshold for CFC status is lowered from 50 to 25 percent.

REASON FOR CHANGE

The lack of clarity under current law as to when transactions involving a captive are considered to be "insurance" has encouraged aggressive planning and excessive controversy. In addition, there is reason to believe that some taxpayers are taking inconsistent positions on these transactions, by using the favorable insurance accounting provisions of subchapter L without paying the federal excise tax on insurance premiums paid to certain foreign insurers and reinsurers.

PROPOSAL

The proposal would provide that an "insurance" arrangement between a captive insurer and any other person (related or unrelated) will be respected as a valid insurance arrangement for tax purposes if less than 50 percent of the captive's net written premiums are attributable to the insurance or reinsurance of risks of related persons. A captive that satisfies this 50-percent threshold would account for its income in accordance with subchapter L, modified in the case of certain foreign captives by the provisions of subpart F. Amounts paid to the captive for the insurance or reinsurance of risks would be treated as insurance premiums by all parties.

The tax treatment of a captive that does not satisfy the 50-percent threshold would be governed by the general provisions of the Code (including subpart F, where applicable) rather than by subchapter L, and its transactions with related persons would not be treated as insurance transactions. Amounts paid by related persons for the insurance or reinsurance of risks would be characterized as payments for risk management services, the deductibility of which would be governed by general Code provisions. Amounts paid by unrelated persons for the insurance or reinsurance of risks would be characterized as insurance premiums. The captive would be allowed to deduct as ordinary and necessary business expenses amounts paid to compensate contractually covered losses of either related or unrelated persons. Subpart F would be amended as necessary to ensure that amounts received by a foreign captive that does not satisfy the 50-percent threshold are included in subpart F income, and that rules similar to certain provisions of section 953(c) apply to income from transactions with related persons.

Amounts paid by unrelated persons to a foreign captive that fails to satisfy the 50-percent threshold would continue to be subject to the federal insurance premium excise tax. Amounts paid by related persons to such a captive would not be subject to the excise tax. A captive that fails to satisfy the 50-percent threshold would not be eligible for tax exemption under Code section 501(c)(15).

For this purpose, related persons would include any 10-percent shareholder of the captive and any person that would be a related person with respect to the captive under rules similar to those of section 953(d)(3). For purposes of the 50-percent threshold, net written premiums would be determined on a three-year rolling average; however, the computation would exclude premiums written in any taxable year beginning before 1996.

The proposal would be effective for taxable years beginning after December 31, 1995.

REFORMULATE PUERTO RICO AND POSSESSIONS TAX CREDIT (SECTION 936)

CURRENT LAW

Domestic corporations with business operations in U.S. possessions (including, for this purpose, Puerto Rico and the U.S. Virgin Islands) may elect under Code section 936 generally to eliminate the U.S. tax on certain income which is related to their possession-based operations. The section 936 credit may offset the U.S. tax on the following types of income: (1) foreign source income arising from the active conduct of a trade or business within a U.S. possession or from the sale or exchange of substantially all of the assets used by the taxpayer in the active conduct of such trade or business, or (2) income from certain investments in the possessions or in certain Caribbean Basin countries ("qualified possession source investment income", or "QPSII"). The credit spares the electing corporation U.S. tax whether or not it pays income tax to the possession.

Limitations on the active-business element of the credit were enacted in 1993. Section 936 companies may elect either a reduced percentage of the profits-based credit as allowed under prior law (60% in 1994, phasing down to 40% beginning in 1998), or a limitation based on the company's economic activity in the possessions (measured by wages and other compensation, depreciation, and certain taxes paid).

REASON FOR CHANGE

The Administration proposed to reformulate the credit in 1993 to make it a more efficient incentive for job creation and economic activity in Puerto Rico; the amendments enacted in 1993 moved part way toward the Administration's proposals. The Administration continues to believe that any credit should provide an incentive for increased economic activity in the possessions rather than merely an incentive to attribute profits there.

PROPOSAL

To provide a more efficient tax incentive for the economic development of Puerto Rico and other U.S. possessions, and to continue the effort toward this goal that was begun in the 1993 Act, the proposal would modify current law to (1) phase-out the profits-based branch of the active-business portion of the credit over five years, beginning in 1997, and (2) allow excess amounts of economic-activity limitation to be carried forward for up to 5 years. The proposal would retain the economic-activity limitation on the active-business portion of the credit and the passive-income portion of the credit for taxes otherwise payable on QPSII, as under present law.

The proposal would be effective for taxable years beginning after December 31, 1995.