Tax Report #952

New York State Bar Association

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May 26, 1999

The Honorable Bill Archer
Chairman
House Ways & Means Committee
1236 Longworth House Office Building
Washington, D.C. 20515

Dear Chairman Archer:

On behalf of the Tax Section of the New York State Bar Association, I enclose two reports relating to various proposals contained in the Year 2000 Budget submitted by The Administration on February 1, 1999.

The first report deals with the proposal to reimpose tax on employee stock ownership plans ("ESOP's") that own shares of stock in Subchapter S corporations. As we indicate in this report, the reintroduction of a tax at the ESOP level on S Corporations earnings represents a partial and imperfect solution to a set of problems that were unsatisfactorily addressed in legislation adopted in 1996 and 1997. We believe that it is appropriate to insure that tax is paid on S Corporation income attributable to the ESOP's interest in the company in a manner consistent with the income tax paid on C Corporation income, without risking the imposition of two levels of tax on the same income. As a consequence, while we generally support the reintroduction at the ESOP level on S Corporation earnings, we propose an alternate method which we believe will answer some of the objections that have been leveled at the Administration Proposal. Furthermore, we suggest further statutory changes to extend benefits to a leveraged S corporation ESOP, and to avoid the reimposition of a tax on the sale by an ESOP of S Corporation shares. We believe that our proposals will serve to encourage the establishment of ESOP's with respect to S corporation shares while assuring the imposition of only one level of tax on S corporation income.

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The second set of reports deals with Proposals in the budget which relate to certain tax accounting provisions. These reports discuss the following proposals:

(I) Repeal of the lower of cost or market inventory method which we support.

(II) Repeal of the non-accrual experience method of accounting which we do not support.

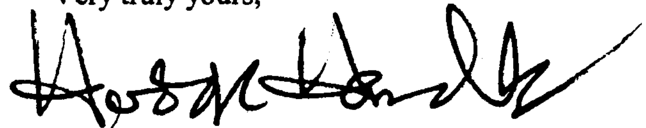
(III) Repeal of the installment method for accrual taxpayers for which we recommend an alternative proposal.

(IV) Application of uniform capitalization rules for contract manufacturers for which we suggest the adoption of expanded regulatory authority to deal with abusive situations.

(V) The extension of Section 381 carryover accounting rules to Section 351 or Section 721 transactions which we support.

We would be pleased to discuss any of these Reports with you or any member of your staff.

Very truly yours,



Harold R. Handler
Chair

cc: James D. Clark

NEW YORK STATE BAR ASSOCIATION TAX SECTION REPORT ON PROPOSED LEGISLATION TO RE-IMPOSE TAX ON S CORPORATION ESOPs

I. Introduction.

This report, prepared by the Committee on Pass-Through Entities of the Tax Section of the New York State Bar Association,[1] comments on the Administration's proposal to re-impose a tax on employee stock ownership plans ("ESOPs") that own shares of stock in S corporations.

The proposal would treat all items of S corporation income passing through to an ESOP shareholder as subject to the tax on unrelated business taxable income ("UBTI"). The proposal would also treat an ESOP's gain on sale or distribution of S corporation stock as UBTI. An ESOP would be permitted to deduct against its UBTI, including as a net operating loss carryback or carryover, amounts distributed to its participants, to the extent that such amounts exceed the ESOP's S corporation income not previously subject to the UBTI tax.

The proposal would be effective for taxable years beginning on or after the date of first committee action, and with respect to any acquisition of S corporation stock by an ESOP (or S election made by a corporation having an ESOP as a shareholder) on or after such date.

II. Background.

ESOPs and certain other tax-exempt entities were first permitted to own S corporation stock by the Small Business and Job Protection Act of 1996 (the "1996 Act"), effective for taxable years beginning after December 31, 1997. The 1996 Act treated all items of S corporation income, and any gain on the disposition of S corporation stock, as UBTI to a tax-exempt shareholder. In the Tax Relief Act of 1997 (the "1997 Act"), the UBTI rule was made inapplicable to ESOPs effective as of the effective date of the 1996 Act.

The Joint Committee of Taxation's analysis of the current proposal explains that under the 1996 Act, items of S corporation income were effectively taxed twice: first as UBTI to the ESOP, and again to the ESOP participants when distributed. The purpose of the 1997 Act was to eliminate one level of tax, such that the S corporation's income would be taxable only to ESOP participants when they receive distributions from the ESOP. The

[1] The principal drafter of this report was Kimberly S. Blanchard. Helpful comments were received from Arthur A. Feder, Robert C. Fleder, Sherwin Kamin, Robert H. Scarborough, Michael L. Schler and Marc L. Silberberg.

current proposal is motivated by a concern that the 1997 Act changes permit inappropriate deferral, and possibly even avoidance, of tax on S corporation income.

III. Recommendations.

While we generally support the reintroduction of a tax at the ESOP level on S corporation earnings, in our view the proposal represents a partial and imperfect solution to a set of problems that were incompletely addressed by both the 1996 and 1997 Acts. For the reasons set forth below, we recommend that any re-imposition of the UBTI tax on S corporation ESOPs be accompanied by an exclusion from tax, at the ESOP participant level, on items of previously-taxed income. We also recommend that gain from the sale of stock of an S corporation not be subject to tax in the hands of an ESOP. We further recommend certain other changes designed to achieve Congress's goal of encouraging ESOP formation by S corporations without creating artificial tax incentives or tax disadvantages.

IV. Technical Comments.

A. Participant-Level-Exclusion in lieu of ESOP-Level Deduction.

Under the 1996 Act, an ESOP shareholder of an S corporation was subject to two levels of tax. As has been pointed out elsewhere,[2] the net effect of that rule, when combined with other provisions of the Code designed to encourage formations of ESOPs by C corporations, was to tax income of an S corporation attributable to an ESOP at an effective combined rate higher than the rate that would be applicable to the income of a C corporation attributable to an ESOP. Under the 1997 Act, all tax on S corporation income attributable to an ESOP was deferred until the ESOP made retirement or other distributions to its participants. The net effect of the 1997 Act was to provide an uncapped retirement savings incentive to S corporations and their employees.

Because neither the 1996 Act nor the 1997 Act rule can be justified on policy grounds, we support the adoption of a middle ground somewhere between the two. The proposal achieves some middle ground, but in practice may produce harsh and probably unintended results similar to the 1996 Act. The ESOP's deduction for distributions paid may in many cases prove unusable. If distributions are paid in a termination year, the restriction on any NOL carryback may limit the ESOP's ability to use the deduction in its final tax year. Even on a normal operating basis, significant timing discrepancies could eliminate the benefit of the deduction. Moreover, the deduction model invariably produces a mismatch between the interests of current and retiring employees. The accounts of current participants will be debited for the tax on UBTI, whereas distributions eventually paid to them will create deductions for the benefit of future participants.

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[2] See Simmons & De Angelis, ESOP-Owned Subchapter S Corporations: A Mistake in Need of a Fix, Tax Notes, March 1, 1999, p. 1325.

A better approach would be to impose the UBTI tax at the ESOP level without benefit of any deduction for distributions, but not to tax ESOP participants on the receipt of distributions from the ESOP to the extent attributable to income previously subject to the UBTI tax. This approach ensures that one level of tax is paid currently on S corporation income in a manner consistent with the income tax paid on C corporation income, without risking possible imposition of two levels of tax on the same income.

Mechanically, the participant-level exclusion from income could be accomplished by creating a notional account within the ESOP (similar to the S corporation accumulated adjustments account) that would measure, over time, the amount of the ESOP's previously taxed income. A possible disadvantage of this approach is that the rate of tax imposed on UBTI may differ from the rate of tax that would be imposed upon its participants had they owned shares of stock in the S corporation directly.[3] If this were perceived as a significant disadvantage, the rate of tax applicable to the ESOP could be set at the rate(s) that would apply to individuals. Alternatively, in lieu of an income exclusion, participants could be given a credit against tax equal to their shares of the tax borne by the ESOP, similar in operation to the credit allowed mutual fund and REIT shareholders for retained capital gains on which an entity-level tax is paid.

B. Leveraged ESOPs.

The proposal also fails to address two potentially significant disadvantages that an S corporation ESOP would bear relative to a C corporation ESOP in the event the UBTI tax is re-imposed. First, the proposal does not extend the same benefits to leveraged S corporation ESOPs as are extended to leveraged C corporation ESOPs. Although an employer's deduction for contributions to an ESOP is generally limited to 15% of compensation paid, this cap is increased to 25% for contributions paid to reduce the principal amount of ESOP borrowings to acquire employer stock, and is uncapped for contributions to pay interest on such debt. These rules do not extend to S corporation ESOPs.[4]

An S corporation ESOP subject to tax on its UBTI would be unable to finance the acquisition of employer stock on the same tax-free basis that a C corporation ESOP can. This discontinuity could be addressed by allowing the S corporation ESOP to deduct from UBTI (and, by definition, from its previously-taxed income account) the amount of S corporation contributions it uses to pay principal and interest on debt incurred to purchase employer stock, up to the same limitations applicable under section 404(a)(3) and 404(a)(9).

[3] In particular, we question whether the ESOP or its participants should bear tax on items of S corporation tax-exempt income.

[4] I.R.C. §§404(a)(3), 404(a)(9), 404(a)(9)(C).

C. Distributions and Dispositions of S Corporation Shares.

The proposal also fails to address another artificial disincentive to the use of ESOPs by S corporations where the ESOP is subject to tax. Under section 402(e)(4)(B) of the Code, neither an ESOP nor a participant recognizes gain or income upon the net unrealized appreciation ("NUA") inherent in employer stock distributed by the ESOP to a participant. Instead, the participant recognizes long-term capital gain (taxable at favored rates) only when he or she disposes of the distributed shares.[5] For a variety of reasons, this deferral benefit may not be available to ESOPs of S corporations. First, because the annual earnings of an S corporation would be taxed to the ESOP whether or not distributed, net unrealized appreciation will not include undistributed earnings, unless the S corporation was a "C" corporation for a period before the S election was made – e.g., if the stock was acquired before 1997 by the ESOP. Second, an ESOP will rarely be in a position to distribute S corporation shares to participants, for fear of disqualifying the corporation's status as an S corporation (e.g., by exceeding the 75-shareholder limitation).

Most significantly, the proposal would reimpose a tax on the sale by an ESOP of S corporation shares.[6] In general there is no reason to impose tax on an ESOP's disposition of S corporation stock and a good reason not to impose such a tax. Section 512(e)(1)(B)(ii) was originally added to the Code to prevent a particular "double benefit" perceived as possible if a shareholder donated S corporation stock to a tax-exempt organization which then promptly tendered it to the corporation for redemption.[7] This abuse is not possible in the case of an ESOP since stock is sold, not donated, to ESOPs and ESOPs do not ordinarily sell stock to the employer corporation except to make distributions to participants. Moreover, in many cases the trustees of an ESOP will be unable to consent to an S election if the ESOP is subject to tax on a sale of S corporation stock, since such tax would result in a heavier tax burden on the ESOP's beneficiaries than if the corporation remained a C corporation. Thus, making the election would be a breach of the trustees' fiduciary duty.

For all the above reasons, disposition of S Corporation stock by ESOPs should not be subject to tax. Upon any distribution of S corporation shares by an ESOP to a participant, the participant should be treated in a manner similar to a participant who receives

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[5] Treas. Reg. § 1.402(a) – 1(b)(1)(i). We note that if tax is imposed when an ESOP disposes of S corporation stock, it will be at a 35 percent rate, rather than the 20 or 10 percent rate applicable to individual capital gains.

[6] While the Administration's proposal would presumably allow a deduction from UBTI for at least the NUA inherent in shares distributed to a participant, we believe that removal of the tax is simpler and more closely achieves parity to the C corporation model. To the extent that the distributee (or any transferee of stock) receives no step-up in basis attributable to his or her share of the S corporation's assets, there is simply no reason to impose a tax on the ESOP.

[7] Testimony of Martin D. Ginsburg, *Hearing relating to Home Office Deductions and Subchapter S Corporation Reforms*, Subcommittee on Taxation, Committee on Finance, U.S. Senate 36 (S. Hrg. 104-241, 1996).

a distribution of C corporation stock, with appropriate basis adjustments to ensure that the ESOP's basis attributable to previously-taxed income (if any) not be taxed twice.

D. Application of Section 1042.

Any new legislative proposal in this area should also consider whether the benefits of section 1042, allowing a shareholder of a C corporation to sell stock to an ESOP and roll over the gain, should be extended to shareholders of S corporations. In the event that the UBTI tax is reimposed, it may be difficult to justify the denial of this benefit to S corporation shareholders. The benefits of section 1042 to a selling S corporation shareholder would usually be smaller than those available to a selling C corporation shareholder in any event, because an S corporation has no ability to defer the shareholder-level tax by deferring distribution of current earnings.[8]

E. Effective Date.

The effective date provisions of the proposal might be viewed as overly harsh, and appear to relate to this proposal's inclusion under the heading "Corporate Tax Shelters." To the extent that the targeted abuse is the inappropriate deflection of S corporation income to ESOPs from taxable shareholders, we would support the effective date as proposed, but limited to such transactions. To the extent, however, that the targeted abuse is the excessive and unlimited deferral of retirement earnings, this benefit seems clearly contemplated by the explicit provisions of the 1997 Act and does not appear to warrant inclusion among corporate tax shelter items. In general, because we believe that more thought needs to be given to the proposal itself, it would seem appropriate to defer the effective date, for all but clearly abusive and unintended uses of S corporation ESOPs, until all of the issues have been addressed.

[8] If the UBTI tax is not re-imposed, one alternative to reduce the perceived abuse potential of the 1997 Act would be to disallow the benefits of section 1042 to C corporation shareholders who sell their stock shortly before the C corporation elects S corporation status.

REPORT OF THE NEW YORK STATE BAR ASSOCIATION TAX SECTION ON CERTAIN TAX ACCOUNTING PROVISIONS CONTAINED IN THE ADMINISTRATION'S REVENUE PROPOSALS FOR THE FISCAL YEAR 2000 BUDGET *

I. Repeal the Lower of Cost or Market Inventory Accounting Method

Description of Proposal

The proposal would repeal both the lower of cost or market method ("LCM") of accounting for inventories and the related provision allowing the writedown of costs of subnormal goods. The proposal, which would not apply to taxpayers with average annual gross receipts of $5 million or less over a three-year period, would be effective for taxable years beginning after the date of enactment, and any resulting Section 481(a) adjustment would be taken into account over a four-year period.

Background and Policy Analysis

Under present law, taxpayers may use LCM in accounting for inventories. The use of LCM was inherited from generally accepted accounting principles ("GAAP"), which embrace the principle of conservatism in the presentation of accounting information in financial statements. Under LCM, the value of ending inventory is written down to its market value if this value is less than the inventory's cost. Treas. Reg. §1.471-2(c). The LCM method does not, however, require (or allow) taxpayers to "write up" inventory if its market value exceeds cost. Under the subnormal goods method, any damaged, obsolete or worn goods may also be written down to their net selling price.

Under current law, taxpayers using LCM do so on an item-by-item basis. Thus, if one inventory item has declined to a market value $10 below its cost, and another inventory item has appreciated in value $10 above its cost, under LCM the taxpayer would take a $10 write-down with respect to the first item while ignoring the offsetting appreciation with respect to the second item. *See* Treas. Reg. §1.471-4(c) ("[T]he market value of each article on hand at the inventory date shall be compared with the cost of the article, and the lower of such values shall be taken as the inventory value of the article.") In addition, under existing law the term "market" for LCM does not mean the price at which the taxpayer could sell the inventory, but rather refers to the price at which a taxpayer could purchase or manufacture the inventory (*i.e.*, the "bid" price or the replacement cost). Treas. Reg. §1.471-4(a); *D. Loveman & Son Export Corp. v. Commissioner*, 34 T.C. 776, 796 (1960), *aff'd per curiam* 296 F.2d 732 (6th Cir. 1962). Consequently, a decline in the replacement cost for an item of inventory is viewed as a decrease in the item's market value, which may trigger an LCM writedown, even though the selling price of the item (reduced by the estimated expenses that would be incurred in selling the property) might still be higher than its unadjusted cost.

* The principal draftsman of these reports was Thomas L. Evans, with helpful comments from Robert Scarborough.

LCM may be defended as improving the accuracy of income measurement. Arguably, a taxpayer owning inventories that have gone down in value has incurred an economic loss, and the taxpayer would be unfairly overtaxed by deferring the loss until the inventory is subsequently sold. Also, an argument could be made that although taxpayers with appreciated inventories are not currently taxed on their unrealized gains, this tax benefit does not justify the denial of a current deduction to taxpayers with depreciated inventories.

Recommendation

We support the Administration's proposals to repeal LCM and the related provision allowing the writedown of costs of subnormal goods. LCM is an inappropriately generous method of accounting which functions in a one-sided manner by allowing taxpayers to deduct unrealized depreciation in inventories, while not requiring them to recognize unrealized appreciation. Although the use of such conservative principles may be appropriate for financial accounting purposes, it is not justified by modern principles of tax policy. To the extent that taxpayers with inventories not currently subject to the provisions of Section 475 wish to adopt a method of accounting allowing them to recognize unrealized losses in inventories, we think consideration might be given to allowing them to elect the use of a mark-to-market system which would take both unrealized gains as well as losses into account.

Technical Issues

The repeal of LCM should not involve technical difficulties, since the methodology largely stands by itself and could be eliminated without creating technical issues in other areas of the law. If, concurrent with the elimination of LCM, taxpayers not currently subject to Section 475 are allowed to adopt a mark-to-market method, it would be necessary to address the issue whether "market" should be defined as the net realizable value of the inventory (as described above) or instead the inventory's "bid" or replacement cost. Moreover, in our view, it would be appropriate to continue to prohibit the use of any such mark-to-market method to taxpayers using the "last-in first-out" ("LIFO") method of valuing inventories. Such a result would be consistent with present law prohibiting the use of LCM by taxpayers using LIFO, which we believe to be justified, given the peculiar advantages present in the use of LIFO.

II. Repeal the Non-Accrual Experience Method of Accounting

Description of Proposal

The proposal would repeal the non-accrual experience method of accounting, which taxpayers performing services are allowed to use under Section 448(d)(5) and Treas. Reg. §1.448-2T. The proposal would be effective for taxable years beginning after the date of enactment, with any resulting Section 481(a) adjustment taken into account over a four-year period. The Senate Finance Committee approved, on May 19, 1999, an education-related bill which substantially adopts the Administration's proposal to repeal the non-accrual experience method.

Background and Policy Analysis

Under present law, some taxpayers performing services use the cash method of accounting, under which no income is reported until payment is received. Such taxpayers include, for example, qualified personal service corporations engaged in performing certain kinds of services specified in Section 448(d)(2) (such as law, medicine, accounting, etc.). Other taxpayers performing services are required, however, to use an accrual method of accounting, under which income is generally reported prior to receipt of payment. The non-accrual experience method allowed by Section 448(d)(5) is an exception that permits persons using an accrual method of accounting for amounts to be received for the performance of services not to accrue any portion of such amounts that (on the basis of experience) will not be collected. The non-accrual experience method is available for any service provider using an accrual method of accounting, and is not confined to receivables relating to "professional" services enumerated in Section 448(d)(2). The method is not available for accounts receivable resulting from (i) lending money or (ii) selling property. Similarly, the method is not available for accounts receivable a taxpayer acquires from other parties, even though the receivables in question may have been generated by the other parties through the provision of services. The non-accrual experience method is not available for accounts receivable with respect to which interest is charged, or for which a late charge is applied for failure to pay amounts due on time.

Under the non-accrual experience method, taxpayers determine their expected uncollectible accounts through the use of a fraction, the numerator of which is the total bad debts sustained over the most recent six-year period, and the denominator of which is the sum of the accounts receivable earned throughout this period. Treas. Reg. §1.448-2T(e). Under the regulations, this method is the *only* formula allowed by which a taxpayer may determine its estimated uncollectible accounts.

The rationale for the non-accrual experience method is that a taxpayer's income would unquestionably be overstated if the taxpayer were required to take the face amount of noninterest bearing accounts receivable into income since, as a general matter, less than 100 percent of the accounts receivable will be collected. In such a situation the face amount of the accounts receivable implicitly include interest, including a risk premium for default. Requiring the taxpayer to recognize this interest "up front" clearly overstates the taxpayer's income.

The rationale for limiting the non-accrual experience method to noninterest bearing receivables is that, to the extent a taxpayer charges interest on its receivables, those receivables are arguably analogous to loans made by a financial institution, such as a bank. Although the bank will not collect all of its loans, the interest rate charged on the loans includes a risk premium which compensates the bank for the credit risk it is taking. On an *ex ante* basis, the interest premium on the "good" loans which eventually pay off will compensate the bank for the credit loss on the "bad" loans which default. Because of the interest rate charged on the loans, which includes this risk premium, the present value of the expected cash flow from all of the loans equals, at least, the face amount of the loans on the date they are made. As a result, no bad debt reserve should be allowed to the bank, because the value of its loans is at least equal to their face amount.

It might be argued that the non-accrual experience method allows certain service providers to use bad debt reserves, which were generally repealed by the Tax Reform Act of 1986 (the "1986 Act").

Recommendation

We recommend that the non-accrual experience method be retained, and thus we do not support the Administration's proposal, including its inclusion in the education-related bill recently passed by the Senate Finance Committee. We do not believe there is any compelling reason for overtaxing service providers by requiring them to include the face amount of accounts receivable into income, when those receivables do not bear interest. We also believe that many service businesses would not find it practical to adjust to the repeal of this method by reducing the face amount of receivables and charging interest that includes a premium for risk of non-payment.

We do not believe that the repeal of bad debt reserves dictates that the non-accrual experience method be similarly abandoned. The non-accrual experience method was enacted as part of the 1986 Act, at the same time that bad debt reserves were repealed. At that time, Congress explicitly recognized that the repeal of the reserve method for bad debts created a need for the non-accrual experience method. Moreover, there is no abuse in allowing the non-accrual experience method to service providers, assuming that such taxpayers do not charge interest on receivables. Under present law, taxpayers charging interest are denied the use of the non-accrual experience method, which is consistent with the intent of the 1986 Act in repealing the use of bad debt reserves for such taxpayers. Thus, in our opinion, it is simply incorrect to argue that the non-accrual experience method provides taxpayers with unwarranted tax benefits, as did reserves for bad debts prior to the 1986 Act.

Although it is true that persons selling property and billing for those sales through non-interest bearing receivables are overtaxed under current law (by being denied the use of the method), we think that is hardly a strong argument for expanding the sphere of overtaxation to include service providers. If anything, consideration should be given to allowing use of the non-accrual experience method by other accrual method taxpayers who do not charge interest on their accounts receivable. Moreover, although the nonavailability of the non-accrual method for the sale of goods may present problems under current law in differentiating between the provision of services and the sale of goods, we do not believe that these problems are especially difficult. Moreover, in our view, they do not justify repealing the use of the method altogether for taxpayers providing services.

Technical Issues

If, contrary to our recommendations, the non-accrual experience method is repealed, we would not anticipate any particular technical problems arising from this change in law. Some taxpayers might respond to the repeal of the method by charging interest on accounts receivable, and by possibly reducing the face amount of their accounts receivable billed to customers, in order to reduce the amount that would have to be included in income. However, that type of practice is commonplace for many accrual method taxpayers under current law, and thus should not create

any particular administrative problems for the Service or for taxpayers.

III. Repeal the Installment Method for Accrual Taxpayers

Description of Proposal

The proposal would repeal the use of the installment method of accounting for taxpayers using an accrual method of accounting, other than certain dealers in property entitled to special installment rules under present law. In addition, as to those taxpayers for whom the method is retained, the proposal would treat granting of "put" rights on an installment obligation as security for a loan (or other similar arrangements) in the same way that current law treats pledging the installment obligation itself as security for a (*i.e.,* the loan proceeds would be treated as payment on the installment obligation, triggering recognition of installment gain). Finally, the proposal would make technical modifications to the subsequent receipt rule of present law applying to the receipt of subsequent payments on an installment obligation after the pledging of the obligation as security for a loan had already triggered recognition of gain. Under present law, subsequent payments received on the installment obligation are not taken into account in triggering installment gain until they exceed the amount of loan proceeds that were previously treated as payments on the installment obligation. The proposal would, subject to certain exceptions, require that the subsequent cash payments trigger additional recognition of gain on the installment obligation, notwithstanding the previous recognition of gain from the pledging of the obligation as security for a loan. The Senate Finance Committee approved, on May 19, 1999, an education-related bill which substantially adopts the Administration's proposal to repeal the use of the installment method of accounting for taxpayers using an accrual method of accounting and to modify the installment sale rules in other respects.

Background and Policy Analysis

As is widely know, the argument in favor of allowing the use of the installment method is based on liquidity concerns, *i.e.,* the ability to pay tax. Since taxpayers selling property under an installment note would not necessarily have the cash available to pay the tax due if all the gain were recognized at the time of sale, the installment method is allowed as a solution to this problem. Under the installment method, the payment of tax is effectively matched with the receipt of cash from the installment note, thus generally ensuring that the taxpayer will have adequate cash to pay its tax liabilities.

Under present law, the use of the installment method is prohibited for most dealers in property, as well as for sales of stock or securities that are traded on an established securities market. This reflects a policy decision that dealers in property are likely to have alternative sources of financing which would allow them to meet their current tax obligations without having to, in effect, borrow from the government through the deferral of tax on the installment sale. Similarly, the denial of the installment method for stock or securities traded on an established securities market reflects the view that such securities are quintessentially liquid, and that taxpayers selling such properties do not have liquidity problems, thus do not need the installment method. In addition, under present law, interest must be paid on the amount of tax deferred under the

installment method for installment obligations arising from sales of property having a sales price over $150,000, but only if the face amount of all the taxpayer's installment obligations that arose during the tax year and are outstanding at the end of the tax year exceeds $5 million. This reflects a policy decision that taxpayers making large installment sales in a year may very well have significant liquidity problems that justify the use of the installment method. It was decided that such taxpayers should at least pay the government an interest charge on the taxes deferred through the use of the method, since those taxpayers would have incurred a similar interest charge had they borrowed money from a private party to finance the payment of taxes and earn (or effectively earn) interest on installment receivables.

Recommendation

We agree that consideration should be given to changing the installment sale provisions in the Code. However, we think that prohibiting the use of the installment method by accrual method taxpayers is overly broad because it applies to an inappropriately large number of taxpayers. Thus, we do not support the Administration's proposal to prohibit the use of the installment method by accrual method taxpayers and its inclusion in the education-related bill recently passed by the Senate Finance Committee. (As discussed below, we *do* support the technical modifications to the installment sale rules also contained in the Administration's proposals.) First, we note that the mandatory use of an accrual method of accounting has been significantly expanded in recent years. Section 448 of the Code, enacted in the 1986 Act, effectively requires the use of an accrual method of accounting for C corporations (as well as partnerships having C corporations as partners) if the taxpayer's annual gross receipts average over $5 million. Numerous corporations and partnerships are thus forced onto the accrual method by Section 448. In addition, the $5 million threshold for applying Section 448 is not in any way indexed for inflation, resulting in the provision applying to more and more entities simply through the process of time. Similarly, many small businesses may be required to use an accrual method of accounting because of the presence of inventories, notwithstanding the fact that these businesses may be small enterprises without access to sophisticated capital markets available to larger corporations. (See Treas. Reg. § 1.446-1(c)(2)(i) which requires the use of an accrual method of accounting when inventories are present in a taxpayer's business.) In our view, being required to use an accrual method of accounting (i) under Section 448 or (ii) due to the presence of inventories, is hardly an appropriate touchstone for prohibiting the use of the installment method. Many small businesses might have legitimate concerns with liquidity problems if they were denied the use of the installment method of accounting, even though these businesses might be currently required to use an accrual method under the Code or regulations thereunder. Conversely, many partnerships and other taxpayers currently allowed to use the cash method of accounting might be far less sympathetic regarding liquidity concerns from installment sales, and as a result would be more suitable candidates for the prohibition of the installment method. In summary, we believe that Section 448 and the other rules requiring the use of an accrual method of accounting (such as the presence of inventories) are too crude to serve appropriately as a benchmark in determining eligibility for the use of the installment method of accounting.

Although we do not support denying use of the installment method to all taxpayers using an accrual method of accounting, we believe that consideration could be given to various proposals

to reduce the number of taxpayers who are allowed to defer tax on the installment method without paying interest of the deferred tax liability. For example, we think that consideration could be given to amending the rules of current law, whereby interest is charged on the deferred tax liability resulting from an installment sale only if the face amount of installment obligations that arose *during the year* and are outstanding at the end of the year exceed $5 million. We believe that strong policy arguments could be made that taxpayers making installment sales which are far smaller in amount should be required to pay interest on the deferred tax. Moreover, the rules could be amended to eliminate the requirement that a minimum dollar amount of obligations must arise *during the course of a single year* in order to trigger the charging of interest on the deferred tax liability. We think these other approaches could be framed in a manner which would be both administrable and sound as a policy matter. In addition, these approaches would be far less arbitrary than using the accrual method as the test to determine eligibility for installment method accounting.

We support the Administration's proposals regarding the two other installment method proposals, which might be characterized as "technical corrections" to the substantive rules. We agree that the granting of "put" rights on an installment obligation as security for a loan, or other similar arrangements, should receive the same tax treatment as pledging the installment obligation as security for a loan (*i.e.*, the loan proceeds would be treated as payment on the installment obligation, triggering recognition of installment gain). We also agree with the proposed modifications to the subsequent receipt rule of current law. We agree that operation of this rule under present law can be unduly generous, and can result in unwarranted benefits which would be properly corrected by the Administration's proposals.

Technical Issues

If, contrary to our recommendations, the installment method of accounting is repealed for accrual method taxpayers, consideration should be given to the effect of the repeal on taxpayers who are not eligible to use the cash method of accounting under Section 448, but who could be using methods of accounting other than an accrual method, such as a long-term contract method of accounting. Section 448 itself does not technically require the use of an accrual method of accounting, but rather only prohibits the use of the cash method of accounting. *See also* Treas. Reg. §1.448-1(h)(3). Perhaps the statute should prohibit the use of the installment method of accounting by any person using an accrual method of accounting, or otherwise not allowed to use the cash method of accounting under Section 448.

With respect to the proposed modifications to the subsequent receipt rule of current law, we agree with the staff of the Joint Committee on Taxation (see "Description of Revenue Provisions Contained in the President's Fiscal Year 2000 Budget Proposal (JCS-1-99, February 22,1999)("JCT Report") at 255), that certain technical provisions should be adopted to prevent the proposed modifications from working unfairly in situations where the amount of the loan secured by the installment obligation decreases as the installment obligation is repaid.

IV. Apply Uniform Capitalization Rules to Certain Contract Manufacturers

Description of Proposal

The proposal would apply the uniform capitalization rules regarding the production of property to "tollers," *i.e.*, certain contract manufacturers who perform manufacturing or processing operations on property owned by their customers. The proposal, which is subject to a small taxpayer exception, would apply to taxable years beginning after the date of enactment and any section 481 adjustment would be taken into account over four years.

Background and Policy Analysis

Under present law, taxpayers who produce tangible property are subject to the uniform capitalization rules of Section 263A. Taxpayers may take the position that the uniform capitalization rules do not apply to their operations if they are not the owners of the property being produced. Certain contract manufacturers ("tollers") perform manufacturing or processing operations on property owned by their customers either for a fee (a "toll") or for a share of the production. These tollers may consider themselves to be outside the scope of the uniform capitalization rules since arguably they are not the owners of the property being produced.

Under the proposal, these tollers would be subject to Section 263A, irrespective of whether the tollers were deemed to be the owners of the property.

Recommendation

We are sympathetic with concerns about inappropriate avoidance of cost capitalization rules, but we believe that this proposal presents significant problems of complexity and administrability. In addition, we are concerned that a statutory provision requiring the capitalization of costs by "tollers" could have unexpected and far reaching implications, because many persons provide services in connection with property that is owned by others. To subject these persons to the uniform capitalization rules could amount to a sea change in our traditional notions regarding capitalization, and would be far broader in scope than is necessary to avoid inappropriate avoidance of cost capitalization rules. Moreover, we believe that business arrangements involving tollers generally are not being conducted with any intention of tax abuse, but rather are arrangements which have naturally arisen to address legitimate business concerns. Thus, we are skeptical as to the existence of significant tax avoidance that would justify the adoption of such a regime.

Rather than adopting this proposal, we recommend that Congress consider a special grant of regulatory authority authorizing the Secretary to issue regulations dealing with the treatment of tollers. This would avoid the risk that Congress will inadvertently make a significant change in capitalization rules with a much broader scope than is necessary to accomplish its objective of dealing with only a few taxpayers engaged in tax avoidance. We believe that the Treasury and Service together could utilize such a grant of regulatory authority to craft regulations with a narrow scope to prevent inappropriate avoidance of cost capitalization rules, while at the same time taking care to avoid creating unnecessary problems of complexity and administrability.

Technical Issues

We do not believe that any change in the law should be confined to the uniform capitalization rules of Section 263A, rather than also applying to the cost capitalization rules of Section 263. Instead, any change in law (whether, as we recommend, it is merely a grant of regulatory authority, or instead is a direct statutory expansion of the capitalization rules), should be based on conforming the treatment of a taxpayer that does not own the property being produced to the treatment of a taxpayer that owns the property. Under this suggestion, taxpayers who are outside the uniform capitalization rules of Section 263A, but are subject to other capitalization rules (such as Section 263) would be similarly treated, regardless of whether they owned the property being produced. Thus, we believe that any rule adopted should apply to Section 263 as well as to Section 263A, assuming that appropriate care is taken to narrow its scope.

V. Methods of Accounting and Section 351 or 721 Transactions.

Description of Proposal

The proposal would extend the provisions of Sections 381(c)(4) and (c)(5), regarding methods of accounting, to assets transferred to (i) a corporation in a Section 351 transaction or (ii) a partnership in a Section 721 transaction. The proposal would apply to transfers after date of enactment.

Background and Policy Analysis

Under present law, taxpayers who participate in corporate reorganizations or certain other transactions are subject to Sections 381(c)(4) and (c)(5) regarding the methods of accounting used by the entities which acquire assets in the reorganization. Generally speaking, these provisions require that the acquiring entities adopt the same methods of accounting for the businesses acquired in the reorganization as are used by the entities transferring those businesses. Thus, if a target corporation using a particular accrual method of accounting merges into an acquiring corporation, the acquiring corporation generally is required to use the same accrual method of accounting for the business acquired from the target. In the event that the business assets of the former target and the acquiring corporation compose an "integrated" business, and the two separate businesses were formerly subject to different methods of accounting, then regulations under Section 382 provide guidance as to which method of accounting must be used by the successor integrated business (the "principal" method).

In contrast, a corporate or partnership transferee of assets in a transaction under Section 351 or 721 is not subject to the provisions of Section 381. Thus, if assets are transferred to an existing corporation or partnership, the transferee entity is required to use its previously adopted methods of accounting for the new assets acquired (absent obtaining consent from the Service to change its method of accounting), unless they form a separate trade or business. *See* Treas. Reg. §1.446-1(d)(1). Moreover, if the assets are transferred to a new corporation or partnership, the transferee entity is free to adopt whatever methods of accounting it desires (subject to other constraints under the law), with respect to the assets acquired. In addition, under current law, a

taxpayer using the last-in, first-out ("LIFO") method of valuing inventories is not allowed to retain its historical LIFO "layers" in a Section 351 transaction to a new corporation. Instead, the historical layers will lose their separate identity, and the inventory will be deemed acquired as a single homogenous unit based on its average historical price.

Recommendation

We generally support this proposal. For many years now some taxpayers have deliberately avoided the effects of certain accounting provisions and manipulated the rules in general by engaging in transfers of assets under Section 351 and 721 to new entities. Although the government has been aware of these efforts, and has developed anti-abuse rules in an attempt to deal with them (*see, e.g.,* Treas. Reg. §1.263A-1(j)(4)), there has been no provision in place to deal systematically with the problem. The proposed change would shut down these opportunities for tax avoidance, and therefore deserves support. In addition, the proposed change would provide more appropriate rules in a situation involving a transfer of LIFO inventories. Present law inappropriately collapses the taxpayer's LIFO layers in a Section 351 transfer to a new corporation. We believe it is more appropriate to preserve those layers, and therefore support the provision on this basis as well.

Technical Issues

We agree with the staff of the Joint Committee on Taxation (see JCT Report at 252) that technical issues may arise in applying the provisions of Section 381, which primarily deal with transfers of trades or businesses, to transfers of assets that do not constitute a trade or business under Section 351 or 721. These provisions generally contemplate the combination of two different businesses. Nevertheless, we do not believe that these technical issues are formidable obstacles that should prevent the enactment of this provision. In this regard, we believe that the principles of Section 381(c)(4) and (c)(5) can be expanded to apply to transfers of assets that do not constitute a trade or business in order to determine the "principal" method of accounting that should be used by the transferee entity. For example, we believe that considerations of the size and materiality of the transferred assets could be utilized in making the determination as to the principal method of accounting that should be applied to the assets transferred in a Section 351 or 721 transaction.