

JCT-DOC, JCS- 33-76, General Explanation of the Tax Reform Act of 1976, JCS-33-76, (December 29, 1976), Part 01 of 11
General Explanation of the Tax Reform Act of 1976, JCS-33-76

December 29, 1976

94th Congress

LETTER OF TRANSMITTAL

CONGRESS OF THE UNITED STATES,

JOINT COMMITTEE ON TAXATION,

Washington, D.C., December 29, 1976. Hon. RUSSELL B. LONG, Chairman, Hon. AL ULLMAN, Vice Chairman, Joint Committee on Taxation, U.S. Congress, Washington, D.C.

DEAR MESSRS. CHAIRMEN: While committee reports explain the position of the House Committee on Ways and Means, or the position of the Senate Committee on Finance, they do not in all cases explain the tax legislation as finally passed by the Congress. This becomes particularly important in the case of major legislation where there are many changes between the bill as passed by the House, or as passed by the Senate, and the bill which finally becomes public law. The Tax Reform Act of 1976, because of its comprehensive scope and because of the many changes which were made in this legislation, both by the Senate and subsequently by the conferees, is an illustration of where the differences were especially significant.

This document represents the effort of the staff of the Joint Committee on Taxation to provide an explanation of the Tax Reform Act of 1976 as finally enacted and is comparable to a number of similar documents prepared by the staff on other revenue acts in recent years. For the most part, where provisions which were unchanged in conference were described in either the House or Senate report, that explanation is carried over in this document. No attempt is made here to carry the explanation further than is customary in the case of committee reports and therefore it does not deal with issues which are customarily explained in regulations or rulings.

The first major part of the document contains a summary of and the reasons previously given for the various provisions. The second part contains the revenue estimates on the legislation as finally enacted and the third part is a general explanation of the provisions appearing in the order in which they appear in the public law.

This material has been prepared by the staff of the Joint Committee on Taxation after the Tax Reform Act of 1976 was passed. It has not been reviewed by the tax committees and therefore only reflects the staff's view as to the intent of Congress. It is hoped that this document will be useful in gaining a better understanding of the Tax Reform Act of 1976.

Sincerely yours,

LAURENCE N. WOODWORTH,

Chief of Staff.

LEGISLATIVE HISTORY OF THE ACT

The Tax Reform Act of 1976 was the result of over two years of legislative deliberations largely during the 94th Congress, although some of the provisions were originally considered by the House Ways and Means Committee during the 93rd Congress.¹ Consideration of the Act in the 94th Congress proceeded on the following schedule:

June 23 through June 25, 1975: Panel Discussions before the House Committee on Ways and Means.

July 8 through July 31, 1975: Hearings before the House Committee on Ways and Means.

November 12, 1975: Bill (H.R. 10612) reported by the House Committee on Ways and Means (House Report 94-658).

December 3 and 4, 1975: Bill considered and passed by the House of Representatives.

March 17 through April 13, 1976; July 20 through 22, 1976: Hearings before the Senate Committee on Finance.

June 10, 1976: Bill reported by the Senate Committee on Finance (Senate Report 94-938): Supplemental report filed by Senate Committee on Finance on July 20, 1976 (Senate Report 94-938, Part 2).

June 16-18, 21-25, 28-30, July 1-2, 20-23, 26-30, and August 3-6, 1976: Bill considered and passed by the Senate.

September 13, 1976: Committee on Conference submitted Conference Report (House Report 94-1515; Senate Report 94-1236).

September 16, 1976: Conference report (and House Concurrent Resolution 751) approved by the House and Senate.

October 4, 1976: Tax Reform Act of 1976 (Public Law 94-455) signed by the President.

I. SUMMARY AND REASONS FOR THE ACT

The Tax Reform Act of 1976 will serve six major purposes. First, it will improve the equity of the tax system at all income levels without impairing economic efficiency and growth. Second, the Act effects important simplifications of the tax system by modifying certain deductions and credits affecting individuals, by increasing the standard deduction to encourage taxpayers to switch from itemizing their deductions to using the standard deduction, and by redrafting complex provisions of the tax law and deleting obsolete and little used provisions. Third, the Act extends the fiscal stimulus provided by the Tax Reduction Act of 1975 and extended by the Revenue Adjustment Act of 1975, and makes permanent part of these tax cuts for individuals. Fourth, the Act encourages capital formation by extending the increased investment credit for four years, by modifying the application of the credit, by extending and revising the incentive for investing in employee stock ownership plans, and by liberalizing the net operating loss carryover. Fifth, it improves the administration of the tax laws by making it more efficient and

strengthening taxpayers' rights. Sixth, the Act makes a major revision in the estate and gift taxes. It reduces the estate and gift tax for small- and medium-sized estates and at the same time eliminates tax avoidance possibilities.

In addition, the Act makes certain changes in the operation of the U.S. International Trade Commission as well as the withholding of preferential trade treatment for countries who aid or abet international terrorists.

A. TAX REVISION

While no one contends that our income tax system does not need improving, it is still widely acknowledged to be the best in the world. The difficulty faced in improving the system is that the American people want different things from their tax system. On the one hand, they want every individual and corporation to pay a fair share of the overall income tax burden. In a system that depends heavily on voluntary compliance with the tax laws, as ours does, tax equity is especially important. However, at the same time, Americans do not want the income tax system to interfere with economic efficiency and growth. This implies that tax changes to promote equity should not retard either the current recovery from what has been the worst recession since the 1930's or impede the long-run growth of the economy. The tax revisions in the Act represent a careful balance between these sometimes conflicting objectives.

The Act contains many tax revisions, described in more detail below, designed to eliminate tax abuses and make the tax system more equitable.

Tax shelter provisions

Congress believed that changes were needed to end the excessive tax deferrals provided by tax shelters, as well as the opportunity they provide to, in effect, convert ordinary income into capital gains. Too many investments have been motivated by excessive concern with the tax benefits associated with them, not their economic merits. In some cases, the manner in which the tax shelters were contrived was questionable even under prior law. In others, individuals were combining provisions of the law, or leveraging them through nonrecourse borrowings, in a way which multiplied severalfold any possible advantages intended by Congress. Such activities reduce citizens' respect for the income tax and represent an inefficient allocation of resources. The Act contains a number of provisions designed to curb these abuses without interfering with economically worthwhile investments.

The Act expands the use of the so-called "recapture" rules to prevent conversion of ordinary income into capital gains in the case of real estate, oil and gas drilling and sports franchises. For oil and gas drilling, farm operations, equipment leasing, and film purchases and production, losses from accelerated deductions are limited to the amount for which the individual is "at risk." This is designed to prevent leveraging of tax shelter benefits through the use of nonrecourse loans. There is also an "at risk" rule for limited partnerships in areas not specifically dealt with by the Act, which should discourage development of new leveraged tax shelters. In addition, in the case of farm syndicates (or passive farm partnerships) and motion picture production companies (and companies producing books, records, etc.), certain costs are required to be capitalized and written off over the productive period of the related assets, or the writeoff is delayed until the items involved are used. For real estate, the Act also requires capitalization of interest and taxes during the construction period.

The provisions relating to various deductions and exclusions in the case of partnerships are tightened so that the deductions or exclusions cannot be allocated among the various partners according to whomever can maximize the tax benefits unless such allocation has substantial economic effect. Also, limits are

placed on the amount of “bonus” first-year depreciation deductions of the partners. The Act requires prepaid interest to be deducted over the period to which it relates and requires use of accrual accounting by many farm corporations. Also, it tightens the existing limit on deductions of excess investment interest.

Minimum and maximum taxes

Congress believed that high-income people and corporations should not be able completely to escape liability for income tax. Preventing this is a major feature of the Act. It greatly reduces the incidence of tax avoidance by high-income people through two related provisions —a stiffer minimum tax on tax-preferred income and a revision in the maximum tax designed to discourage use of tax preferences.

Minimum tax

The prior minimum tax for individuals was inadequate. In 1974 it raised only \$130 million, down from \$182 million in 1973, which is only a small fraction of total tax-preferred income. Also, the minimum tax for individuals was largely a tax on one preference —the excluded half of capital gains. The Act amends the minimum tax both to increase its revenue yield and to broaden the tax preferences covered by it.

The Act raises the minimum tax rate from 10 percent to 15 percent. In place of the existing \$30,000 exemption and the deduction for regular income taxes, the Act has an exemption for individuals equal to one-half of regular income taxes or \$10,000, whichever is greater. These changes reflect Congress' view that the effective tax rate on tax preferences should be higher.

Two new minimum tax preferences are added. To reduce the tax benefit of shelters in oil and gas drilling and to ensure that oil drillers pay some minimum income tax, the Act adds a preference for intangible drilling costs. To impose some tax in cases where there is excessive use of itemized personal deductions, there is a new preference for itemized deductions (other than medical expenses and casualty losses) in excess of 60 percent of adjusted gross income.

Congress also believed that the minimum tax on corporations should be strengthened in order to raise the effective tax rate on corporate tax preferences. However, because corporate income is subject to both the individual and corporate income taxes, Congress felt it was appropriate to retain in full the deduction for regular taxes for corporations.

Maximum tax

In 1969, Congress enacted a 50-percent maximum marginal tax rate on income from personal services. To reduce the incentive to invest in tax shelters, the law provided that income eligible for this maximum rate be reduced by tax preferences (as defined under the minimum tax) in excess of \$30,000. The Act extends this 50-percent maximum rate to deferred compensation (including pensions and annuities).

The “preference offset” in the maximum tax has not been as effective in discouraging investment in tax shelters as originally planned. The expanded list of minimum tax preferences will make the preference offset more effective. Also, the Act repeals the existing \$30,000 floor on preferences that reduce personal service income eligible for the maximum tax.

Business expenses under the individual income tax law

Many individuals are now claiming deductions for the business use of their home, for expenses related to the rental of their vacation homes for a brief part of the year, or for expenses of attending foreign conventions. While in theory there is nothing wrong with appropriate deductions for business or investment expenses, in practice it is often extremely difficult to allocate between deductible business expenses and nondeductible personal expenses. The result is that many people have been deducting amounts as business expenses which in part actually represent personal expenses. To deal with this problem, the Act places strict limitations on these deductions.

The Act also repeals the special tax treatment for qualified stock options. With personal service income subject to a maximum rate of 50 percent, Congress decided that there is no reason for not taxing this form of compensation as ordinary income.

Tax treatment of foreign income

The Act makes several important changes in the tax treatment of foreign income. Congress believed that it is necessary to strike a delicate balance between encouraging the free flow of capital across national borders and making sure that the tax laws do not provide excessive incentives for foreign investment instead of investment in the United States. Congress decided to retain the basic structure of the taxation of foreign income —namely, a foreign tax credit for income earned abroad and deferral of tax on income of foreign subsidiaries (except in the case of “tax haven” income) until returned to this country. However, the Act eliminates virtually all other tax-related incentives for investment abroad.

An important change made by the Act is the repeal of the per-country limitation on the foreign tax credit. The per-country limit enables a firm with a loss in one country and a profit in another to deduct the loss against U.S. income and still avoid U.S. tax on the profit through the foreign tax credit. Its repeal will eliminate this possibility and will also greatly simplify this part of the tax law. The Act also provides for recapture of foreign losses deducted from U.S. income when foreign profits are earned in subsequent years.

The Act repeals numerous tax incentives which favor investment in some foreign areas over others —those which favor investment in less-developed country corporations, China Trade Act corporations and Western Hemisphere trade corporations. It also substantially revises and improves the tax provisions relating to U.S. possessions. Except in the case of U.S. possessions, Congress felt that there was no longer any good reason for favoring investment in one of these foreign areas over another.

The Act, while retaining an exclusion for income earned abroad by individuals, eliminates special features of this provision enabling those with income above the basic exemption levels to obtain additional tax benefits from the exclusion and reduces the maximum amounts eligible for the exclusion. Congress did not feel that the tax preference for income earned abroad should be as large as it was under prior law.

Another area of concern is the DISC provision that permits deferral of tax for one-half of export income. To make this incentive more efficient, the Act limits DISC treatment to the excess of a firm's exports above a moving base period level.

Congress did not believe that multinational corporations should benefit from tax incentives when they engage in misconduct. Thus, the Act denies the foreign tax credit, tax deferral, and DISC treatment for income earned in connection with participation in international boycotts, such as the Arab boycott of Israel. Similarly, it provides that amounts paid as bribes by foreign subsidiaries will be taxed to the U.S. parent

corporation.

To eliminate the possibility that oil companies which operate abroad gain undue advantage from the characterization of their payments to foreign governments as creditable taxes, the Act further limits the extent to which foreign tax credits from oil extraction can be used while continuing the requirement that these taxes may not reduce the tax on other foreign oil income.

The Act also makes several technical corrections that were considered necessary resulting from the changes in the taxation of foreign income made by the Tax Reduction Act of 1975.

Capital gains and losses

The Act makes three important changes in the tax treatment of capital gains and losses. The holding period defining long-term capital gains, which receive preferential tax treatment, is raised (over a period of two years) from six months to one year. This should encourage longer term investments as contrasted to short-term speculative investments. Also, the Act (over a period of two years) increases the amount of ordinary income against which capital losses can be deducted from \$1,000 to \$3,000. This change is designed to provide relief to those who have capital losses in excess of capital gains, which is not only fair but also should encourage individuals to make equity investments. Finally, the Act increases the exemption level for capital gains on the sale of a principal residence by a taxpayer age 65 or over.

Other tax revisions

The Act makes a large number of other relatively minor revisions in the tax law. These deal with inequities or technical problems that have come to the attention of the Congress.

There are several provisions relating to tax-exempt organizations. Among these is one which sets the payout requirement (if larger than actual earnings) for foundations at 5 percent of asset value (instead of a minimum of 6 percent) and provides that this limit is not to be varied as interest rates generally change. A second provision sets up a court review procedure where the IRS holds that an organization does not qualify for exempt status. A third change makes more specific the rules for lobbying by charitable and educational organizations.

The Act includes a number of provisions relating to pensions. Probably the most important of these is one which expands the existing provision for individual retirement accounts (IRAs) to permit a working spouse to set up an IRA for a nonworking spouse. This change recognizes the contributions to the family made by nonworking spouses. If an IRA is set up for both spouses, a \$1,750 contribution limit applies. Contributions can be made, subject to that limit, to a single IRA with separate subaccounts or two separate IRAs. Another pension provision permits an amount of up to \$750 to be set aside each year in an H.R. 10-type plan where income is \$15,000 or under without the amount set aside being limited to 25 percent of an individual's earnings.

There also are a number of changes relating to the taxation of insurance companies. Among these is one which, after a period of five years, will permit casualty insurance companies to file consolidated returns with life insurance companies but in a manner which does not permit the losses of the casualty companies to remove more than a limited amount of the life insurance income from taxation.

There are technical changes in the tax treatment of real estate investment trusts, housing cooperatives and condominiums, certain franchise transfers, authors and publishers, creditors of political parties, subchapter

S corporations, the work incentive (WIN) tax credit, personal holding companies, oil and gas producers, losses from disasters, simultaneous liquidation of parent and subsidiary corporations, gain from sales or exchanges between related parties, and deductions for removing architectural and transportation barriers for handicapped and elderly people.

The Act makes revisions in depreciation rules designed to encourage rehabilitation of historic structures.

Several tax provisions that have recently expired are extended in the Act. These include rapid amortization provisions for pollution control facilities and rehabilitated low-income housing. Pollution control facilities are also given half of the normal investment credit, which differs from the prior provision under which 5-year amortization was an alternative to the investment credit. Congress believed that since Federal regulations require installation of pollution control equipment, it is equitable to reduce the cost of capital for such equipment. Also, the exclusion from income for certain forgiven student loans is extended through 1978. Further, the Act extends for a limited period the exclusion for certain health-related scholarships for members of the uniformed services for those participating in 1976.

Tax exemption is provided for contributions by employers to qualified group legal services plans, designed to encourage use of this fringe benefit.

To broaden the market for State and local government bonds, mutual funds are allowed to pass through tax-exempt interest on such bonds to shareholders.

Also, the Act redefines income or loss from writing options as short-term capital gain or loss in order to limit the tax shelters that have developed in recent years in stock option hedges.

In addition, the Act makes certain small changes in the excise tax treatment of truck modifications and truck parts and accessories, and simplifies and revises the excise tax treatment of cigars.

B. TAX SIMPLIFICATION

Tax simplification is the second major goal of the Act. Simplification must be an ongoing process, and the individual provisions of the tax law must be reexamined periodically to see how they contribute to the complexity of the tax law. Unless this reexamination occurs, the tax law will grow gradually more complicated as new provisions are added to achieve new goals of society. The Act repeals or restructures several provisions of the tax law, and directs that a Congressional study be made regarding further simplification of the tax system.

One such provision concerns the use of the income tax tables. The Act eliminates the existing tax tables based on adjusted gross income, which have been a major source of taxpayer error, and substitutes a simpler set of tables based on taxable income. It also raises to \$20,000 the taxable income level where these tax tables may be used.

A second simplification concerns the retirement income credit. This was originally designed to give those who retire without social security a tax benefit similar to that accorded social security benefits. As a result, eligibility for the credit and its computation were designed to follow as closely as possible eligibility for, and computation of, social security benefits. This required a complex form that filled a whole page, and it is estimated that a large fraction of the people eligible for the credit either did not claim it or made errors in computing it. In response to this problem, Congress restructured the credit to eliminate virtually all the complexity, even though this means breaking the close link between the retirement income credit and social security eligibility. This new credit for the elderly also will be fairer than the retirement income credit under prior law since it will also be applicable to earned income for taxpayers age 65 or over.

Another complicated provision has been the sick pay exclusion. In this case, Congress concluded that the exclusion should be allowed only for persons who are permanently and totally disabled, since for other people there is no reason why sick pay should be treated more favorably than wage income, particularly in view of the deductibility of medical and drug expenses. For those still eligible for the sick pay exclusion, the provision has been considerably simplified and coordinated with the new credit for the elderly.

The Act makes major changes in the treatment of child and dependent care expenses. Formerly, these were allowed as an itemized deduction, subject to some complicated limitations. The Act converts the deduction into a 20-percent credit, so that it will be available to those who use the standard deduction as well as to itemizers and so that it will provide the same tax relief to taxpayers in low brackets as to those in high brackets. The child care deduction in prior law was worth, for example, 70 cents for each dollar of child care expenses for a taxpayer in the 70-percent bracket, but only 14 cents to a low-bracket taxpayer who itemized deductions and nothing to someone who used the standard deduction. The new credit will be worth 20 cents for each dollar of qualified child care expenses for all taxpayers. In addition, the Act significantly simplifies the child care provision and broadens eligibility for it.

The Act makes several other changes that will simplify the law or make it more equitable, including a revision of the rules relating to accumulation trusts and the moving expense deduction. The alimony deduction is moved from an itemized deduction to a deduction in determining adjusted gross income, so that it can be used by people who take the standard deduction.

There are some cases where it is possible to achieve tax simplification without changing the substance of the law. The Act includes the so-called “deadwood provisions” which deletes obsolete and rarely used parts from the Internal Revenue Code and makes many other changes to shorten and simplify the language of the Code.

These provisions are only the beginning of what must be a continual process of tax simplification. Congress plans further tax simplification measures and has directed the Joint Committee on Taxation to conduct a comprehensive study of ways to simplify the tax system (with a report to the House Ways and Means and Senate Finance Committees due by June 30, 1977).

C. EXTENSION OF TAX REDUCTIONS

Economic conditions

A third major purpose of the Tax Reform Act of 1976 is to extend the fiscal stimulus provided by the Tax Reduction Act of 1975 and subsequently extended for the first half of 1976 by the Revenue Adjustment Act of 1975. The Tax Reduction Act of 1975 provided a tax cut, a tax rebate and increased expenditures totaling \$23 billion in 1975.¹

The 1975 tax cut included a temporary increase in the standard deduction and a \$30 nonrefundable tax credit for each taxpayer and dependent, which reduced tax liability by \$8 billion and was reflected in lower withheld and estimated tax payments over the last 8 months of 1975. There was also an earned income credit involving \$1.4 billion and a home purchase credit amounting to about \$0.6 billion. Finally, there were business tax reductions—an increase in the investment tax credit and a corporate rate cut for small businesses—amounting to \$5 billion.

The 1975 increase in the standard deduction and the \$30 credit, which reduced tax liability by \$8 billion,

were reflected in lower withheld and estimated tax payments over the last 8 months of 1975 at the rate of \$1 billion per month, or \$12 billion per year. In the Revenue Adjustment Act of 1975, Congress decided to extend these same withholding rates for the first half of 1976 and to provide a cut in tax liability for 1976 approximately equal to this \$6 billion reduction in withholding. Also, that Act extended the small business tax cuts and the earned income credit for the first half of 1976. (The increase in the investment credit had been put into effect for 1975 and 1976 in the Tax Reduction Act.)

Congress analyzed economic conditions again in 1976 and believed it was inappropriate to withdraw the economic stimulus provided by the 1975 tax reductions. Due in no small part to the 1975-76 tax reductions, there has been an overall economic recovery from the 1974-75 recession in the past 18 months. Output has grown at a rate of more than 6 percent, and we have exceeded the level of income and production that existed at the end of 1973, prior to the recession. Since then, however, the capacity of the economy has grown and will continue to grow, and the economic forecasts examined by Congress indicated that there is likely to be excess capacity in the economy for at least the next year. While the unemployment rate had fallen from 9 percent to 7.8 percent (at the time of passage of the Tax Reform Act), the existing unemployment rate was still considered to be unacceptably high. For these reasons, Congress agreed to extend the existing tax cuts at least through 1977 and to make part of the tax cuts permanent.

Congress did not believe that a permanent extension of the entire \$20 billion in tax reductions then in effect was appropriate. There was uncertainty about just how much excess capacity there was (or was likely to be) in the economy, how serious the inflation problem would be in the years ahead, as well as what budgetary requirements would be necessary for the rest of the decade.

In view of the uncertain economic and budgetary situation, Congress agreed to make part of the \$20 billion tax reduction permanent but to extend the rest only temporarily. This will afford Congress and the Administration an opportunity in 1977 to review economic conditions and the fiscal requirements to see what, if any, further extensions or enlargements of these tax cuts should be made.

Individual tax reductions

The Act makes permanent \$4 billion of individual tax reductions. These result from the increases in the standard deduction. The Act extends through 1977 the general tax credit adopted in the Revenue Adjustment Act and the earned income credit, which together involve a tax cut of \$11 billion for 1977.

The Act permanently increases the minimum standard deduction (or low-income allowance) from \$1,300 to \$1,700 for single returns and to \$2,100 for joint returns. It increases the percentage standard deduction from 15 percent to 16 percent. Also, it increases the maximum standard deduction from \$2,000 to \$2,400 for single returns and to \$2,800 for joint returns. This will reduce tax liability at an annual rate of \$4.2 billion for 1977, and will lower budget receipts in fiscal year 1977 by \$4.1 billion. This increase in the standard deduction represents a major simplification of the individual income tax, since it will make it worthwhile for filers of 9 million tax returns to switch to the standard deduction. Also, this change creates greater tax equity, since itemized deductions have been free to rise with inflation, while the minimum and maximum standard deductions stay constant unless there is specific legislative action.

There is also an extension of the earned income credit through 1977. This is a refundable credit equal to 10 percent of the first \$4,000 of earnings, with a phaseout as income rises between \$4,000 and \$8,000. It is available only to people with dependent children. It involves a cut in tax liability in 1977 at a rate of \$1.3 billion, and a reduction in fiscal year 1977 budget receipts of \$0.7 billion. The earned income credit provides a work incentive for those with jobs that pay relatively low wages. It provides desperately needed tax relief to a hard-pressed group, who are faced with high food and energy prices and are subject to the payroll tax.

The Act extends through 1977 the general tax credit for individuals adopted in the Revenue Adjustment Act, which reduces tax liability in 1977 at an annual rate of \$10.1 billion. The extension of this credit will reduce fiscal year 1977 receipts by \$9.5 billion. This credit equals the greater of \$35 for each taxpayer and dependent or 2 percent of the first \$9,000 of taxable income.

Together, the individual tax cuts amount to a cut in tax liability in 1977 at an annual rate of \$15.6 billion. They will reduce budget receipts in fiscal year 1977 by \$14.4 billion.

Business tax reductions

In order to provide sufficient economic stimulus and to encourage businesses to invest, the Act extends the business tax cuts provided by the Tax Reduction Act of 1975. These reduce tax liability in 1977 at an annual rate of \$5.4 billion and will reduce tax receipts in fiscal year 1977 by \$3.0 billion.

As discussed later under *Capital Formation*, the Act extends through 1980 the current 10-percent investment credit (applicable previously through 1976). This represents an increase from the previous 7-percent rate for most businesses and from the 4-percent rate for public utilities. These changes will reduce tax liability by \$3.3 billion in 1977, and will lower budget receipts by \$1.3 billion in fiscal year 1977.

The investment credit has proven an effective way to stimulate investment in equipment. Its enactment in 1962 and its reenactment in 1971 were followed by investment booms, and its suspension in 1966 and repeal in 1969 were followed by sharp declines in investment. Increased investment in the U.S. economy is needed to improve our standard of living and to achieve energy, environmental and other goals; and under these circumstances, Congress believed an extension of the 10-percent investment credit was appropriate. The credit for utilities is increased to the same rate as that for other businesses because Congress believed they should be able to compete for capital on the same basis as other industries.

The Act also extends through 1977 the small business tax cuts enacted in 1975. These increase the corporate surtax exemption from \$25,000 to \$50,000 and reduce the tax rate on the initial \$25,000 of corporate income from 22 percent to 20 percent. The reduction in tax liability is \$2.1 billion in 1977, and the reduction in budget receipts is \$1.7 billion in fiscal year 1977. This change will improve the competitive position of small business.

D. CAPITAL FORMATION

A fourth major aspect of the Act is the encouragement of capital formation through the continuation and modification of certain investment-related tax incentives. Congress was concerned that the U.S. economy faced a severe shortage of capital. In 1973 and early 1974, there were capacity shortages in many major industries because investment in them had been inadequate in the previous five years. Also, the growth rate of labor productivity has slowed, again partly because of inadequate capital investment. We have had the most success in stimulating capital investment in recent years by the use of the investment tax credit. There appears to be a close correlation since 1962 between the presence of the investment credit and purchases of equipment. As a result, the Act extends the 10-percent investment credit for four years (or through 1980).

The Act extends and expands a provision enacted in 1975 allowing an additional one-percent investment credit if an equivalent amount is placed in an employee stock ownership plan. These changes should significantly increase the extent to which the provision is used by business. Under the new law, a credit of an additional one-half percentage point is also allowed if it is matched with employee contributions. This option is considered desirable in order to broaden employees ownership in business and thereby increase

their interest in improving productivity. It will also serve the twin goals of increasing capital accumulation and creating a more equal distribution of wealth. To make the investment credit available to less profitable businesses, the Act makes it available on a first-in, first-out basis.

Another provision to promote capital accumulation, which will be especially important for new business, is one that extends the net operating loss carryforward period to 7 years. By allowing more flexibility in averaging profits and losses, this will encourage risktaking. It will also encourage investment in new businesses. The Act tightens the existing rules to prevent “trafficking” in losses in order to reduce any tax incentives toward business mergers. In addition, the capital loss carryover period for mutual funds is extended from 5 years to 8 years.

For railroads and airlines, industries which have had trouble generating internal funds as a result of the recession, the Act provides (for a limited period of time) a tax reduction through changes in the investment credit and in amortization rules. For similar reasons, at least half investment credit is made available to the domestic merchant marine for funds withdrawn from their tax-deferred ship construction fund to purchase ships.

Finally, the Act, in order to encourage domestic production, makes the investment credit available in the future for motion picture productions only where they are predominantly American-produced films. For the past, a compromise between the Internal Revenue Service and the industry is worked out as to the appropriate investment credit intended under the relatively uncertain provisions of prior law.

E. ADMINISTRATIVE PROVISIONS

A fifth major goal of the Act is to improve the administration of the tax laws. It contains several provisions to improve efficiency of tax administration through changes in withholding provisions and better regulation of tax return preparers. It also makes significant administrative changes designed to strengthen taxpayers' rights.

The Act provides definitive rules relating to the confidentiality of tax returns, an area where there has been abuse in the past. It strictly limits disclosure of information from tax returns. The ability of the Internal Revenue Service to use jeopardy and termination assessments and to issue administrative summons also is limited by providing better court review in these cases.

At the same time, rules are provided for the publication of private letter rulings so everyone will have an equal opportunity to know the view of the IRS on the proper interpretation of the tax law. New rules are also added to aid the Service in reviewing the way in which tax return preparers carry out their duties.

In the case of withholding tax provisions, a number of changes are made, including provision to withhold at the rate of 20 percent on income from most wagering where the amount won is \$1,000 or over. Further, in the case of fishing vessels where the catch is shared, sternmen are classified as independent contractors for tax purposes. The Act also provides mandatory withholding of State and local income taxes for members of the Armed Forces.

F. ESTATE AND GIFT TAX PROVISIONS

The estate and gift tax provisions provide a comprehensive revision of these taxes. In this area, the Act provides substantial relief for moderate-sized estates, farms and other closely-held businesses, alleviates the liquidity problem for estates comprised largely of farms and other closely-held business, while at the same

time it removes tax avoidance devices from the present system. This is accomplished with a balanced set of provisions which in the long run will at least maintain the present level of revenues.

The Act substantially reduces estate taxes for medium-sized estates. The existing \$60,000 estate tax exemption was enacted in 1942 and since that time the percentage of decedents whose estates have been subjected to the Federal estate tax has increased from 1 percent to 8 percent. This increase has resulted from inflation and the greater ability of people to accumulate wealth because of the unprecedented economic prosperity in the post-war era. The Act increases from \$60,000 to \$175,000 the level at which the taxation of estates begins. It also changes the exemption into a tax credit in order to confer the maximum possible tax relief on the small and medium-sized estates.

In addition, the prior estate tax imposed acute problems when the principal asset of the estate was equity in a farm or small business. Because assets are valued at their "highest and best use" for estate tax purposes, rather than on the basis of the specific use to which the assets were being put (and also because these assets are illiquid), family members have often been forced to sell farms and small businesses in order to pay the estate tax. To deal with these problems the Act allows farms (and other family businesses) to be valued (to the extent of \$500,000) at the value for farming purposes (or other small business use), if they remain in the family for a period of ten to fifteen years after the death of the decedent, rather than being valued at the "highest and best use" market value. Also, in these cases, the Act extends the time for payment of estate tax liability and provides for a low 4-percent interest rate on the tax on up to \$1 million of farm or small business value. These changes are intended to preserve the family farm and other family businesses —two very important American institutions, both economically and culturally.

The estate and gift tax structure is an important part of the Federal tax system and as such needs to be as nearly equitable as possible in its application. Tax liability should not depend on the method used to transfer the property from one generation to the next. Because of this, a number of steps were taken to reform the estate and gift tax provisions. This reform provides assurance that in the long run these provisions will not lose revenue.

Two features of prior law which give rise to considerable variations in estate and gift tax burdens for people who transfer the same amount of wealth were the separate rate schedule and exemption provision for estates and gifts. There were several tax advantages to lifetime gifts. The gift tax rates were 75 percent of estate tax rates; and, unlike the estate tax, the amount of the gift tax itself was not included in the tax base. Also, someone who split his total transfers between gifts and bequests achieved the advantage of "rate splitting," since the first dollar of taxable bequests was taxed at the bottom estate tax rate even where there had been substantial lifetime gifts. These opportunities for reducing the overall burden by lifetime giving were inequitable, especially since many people are not wealthy enough to make lifetime gifts. The Act unifies the estate and gift taxes —both the exemptions (which have been converted into a credit) and the rates —to deal with these inequities.

Another cause of unequal treatment of taxpayers with the same amount of wealth transfers has been the ability to use "generation skipping" trusts. When wealth is bequeathed from the parent to his child, then from the child to a grandchild and finally from the grandchild to a great-grandchild, the estate tax is imposed three times. However, if the parent places the wealth in a trust in which the child and then the grandchild has the right to the income from the trust, with the principal going to the great-grandchild, the parent will achieve virtually the same result and, in effect, skip two generations of estate tax. In these cases, the estate tax could be avoided for 100 years or more under prior law. Since such trust arrangements have been used largely by wealthier people, this failure to tax generation-skipping trusts has undermined the progressivity of the estate and gift taxes. The Act significantly limits estate tax avoidance through generation-skipping trusts by imposing a tax at the time of the death of the child or grandchild, in the example cited above, of substantially the same size as would be imposed had the property passed directly from the child to the grandchild and to the great-grandchild, although the additional tax in this case is payable by the trust. However, an exception to this rule is provided for up to \$250,000 passing from a child to one or more grandchildren.

Still another inequity in the prior law resulted from the fact that when appreciated property was transferred at death, the basis of the property for the heirs (on which any capital gain or loss is computed) was the fair market value at the time of death rather than the basis of the decedent. This contrasted with the rule for gifts, where the donee must carry over the basis of the donor. One unfortunate result of the prior law has been that people were reluctant to sell appreciated property in anticipation of the step-up in basis at death. Another result has been that assets accumulated out of savings from ordinary income bore a heavier total tax burden than those resulting from appreciation in value where the gain had not been realized. To reduce the inefficiency and inequity of the prior system, the Act generally provides for a carryover basis at death but provides, however, that there will continue to be a step-up in basis for appreciation which has occurred through the end of the calendar year 1976.

G. INTERNATIONAL TRADE AMENDMENTS

Another area of the Act involves changes in the operation of the U.S. International Trade Commission and amendments to the Trade Act of 1974 regarding tariff treatment of countries aiding or abetting international terrorists.

The Congress concluded that the voting procedures of the International Trade Commission needed revising in order to facilitate the functioning of the Congressional override mechanism in cases where a plurality of three commissioners reached agreement on a particular remedy but, because a majority of the commissioners voting did not agree on a remedy, there was no "recommendation" by the Commission which Congress could implement under the override provisions (contained in the Trade Act of 1974). Thus, the Act provides that if a majority of the Commissioners voting on an escape clause or market disruption case cannot agree on a remedy finding, the remedy finding agreed upon by a plurality of not less than three Commissioners is to be treated as the remedy finding of the Commission for the purposes of the Congressional override mechanism. The Act also modifies the rule for the term of office for a member of the Commission so that a Commissioner may continue to serve after the expiration of the term of office until the successor is appointed and qualified.

In addition, the Act amends the Trade Act of 1974 to add a new category of reasons for denying preferential tariff treatment to "beneficiary developing countries." The new provision would prohibit preferential tariff treatment to such countries that aid or abet any individual or group which has committed an act of international terrorism. The President, however, could waive this prohibition (as he may for certain of the other categories for denial of preferential treatment) if a waiver is determined to be in the national economic interest of the United States.

II. REVENUE EFFECTS

Table 1 gives the revenue effects of the tax reform, estate and gift tax, and tax cut provisions of the Act, and lists the revenue impact of each title of the Act. As the table indicates, the tax reform provisions are estimated to raise about \$1.6 billion in revenues in fiscal year 1977 and \$2.5 billion by 1981. The tax cut extension amounts to \$17.3 billion in 1977. The title-by-title analysis of the table indicates that \$417 million of revenue will be raised from tax shelter provisions in 1977, a figure which rises to \$527 million by 1981.

Table 2 lists the revenue effect of each section of the Act by title.

Tables 3 and 4 give the estimated decreases in individual income tax liability for calendar year 1977 and 1978 under the tax cut extensions contained in the Act.

TABLE 1.—REVENUE EFFECT OF TAX REFORM, ESTATE AND GIFT TAX, AND TAX CUT PROVISIONS OF THE ACT, SUMMARY AND BY TITLE¹
 [In millions of dollars; fiscal years]

	1977	1978	1979	1980	1981
SUMMARY					
Tax reform	1,593	1,719	2,038	2,118	2,470
Estate and gift tax		-728	-921	-1,134	-1,449
Extension of tax cuts	-17,326	-13,776	-7,966	-8,348	-7,212
 Total	 -15,733	 -12,785	 -6,849	 -7,364	 -6,191
BY TITLE					
II --Tax shelters	417	395	501	488	527
III --Minimum and maximum tax	1,095	1,283	1,464	1,603	1,758
--Extension of individual IV income tax reductions	-14,350	-9,293	-4,506	-4,731	-4,968
--Tax simplification in V the individual income tax	-409	-442	-457	-478	-499
--Business related individual income tax VI provisions	215	231	273	306	315
VII --Accumulation trusts	(2)	(2)	(2)	(2)	(2)
VIII --Capital formation	-1,457	-3,593	-3,796	-4,000	-2,499
--Small business IX provisions	-1,676	-1,177			
--Changes in the X treatment of foreign income	150	108	182	197	198

--Amendments affecting XIDISC	468	553	559	598	728
--Administrative XIIprovisions	88	55	55	55	55
--Tax exempt XIIIorganizations	-5	-5	(2)	(2)	(2)
--Treatment of certain capital losses; holding period for capital gains XIVand losses	-6	10	79	73	58
--Pension and insurance XVtaxation	-18	-29	-29	-31	-30
--Real estate investment XVItrusts	(2)	(2)	(2)	(2)	(2)
XVII --Railroad provisions	-87	-139	-118	-98	-80
--International Trade XVIIIamendments					
XX --Estate and gift taxes		-728	-921	-1,134	-1,449
--Miscellaneous XXIprovisions	-158	-14	-135	-212	-305
Total	-15,733	-12,785	-6,849	-7,364	-6,191

¹ Does not include Title I --Short Title and Title XIX --Repeal and Revision of Obsolete, Rarely Used, Etc., Provisions.

² Less than \$5,000,000.

TABLE 2. —REVE

estimates are as follows:

unified rates and credit, -\$1.23

billion; marital deduction, -\$153 million;

valuation, -\$14 million;

extension of time, less than \$500,000;

unification, \$300 million;

generation skipping, \$280 million;

carryover of basis, \$1.08 billion;

and total, \$263 million.

TABLE 3. —INDIVIDUAL INCOME TAX BURDEN ¹ IN 1977 UNDER THE STANDARD DEDUCTION, ² \$35 PER CAPITA CREDIT, THE 2-PERCENT ALTERNATIVE CREDIT UP TO \$180, AND THE 10-PERCENT EARNED INCOME CREDIT OF P.L. 94-455 COMPARED TO 1974 LAW [Single person and married couple with 0, 1, 2, and 4 dependents (assuming deductible personal expenses of 17 percent of income).]

Single person	Tax liability														
	Married couple with no dependents		Married couple with 1 dependent		Married couple with 2 dependents		Married couple with 3 dependents		Married couple with 4 dependents						
Adjusted gross income	Under 1974P.L.	Under 1974P.L.	Under 1974P.L.	Under 1974P.L.	Under 1974P.L.	Under 1974P.L.	Under 1974P.L.	Under 1974P.L.	Under 1974P.L.	Under 1974P.L.					
\$3,000	\$138	\$43	\$95	\$28	0	\$28	0-\$300	\$300	0-\$300	\$300	0-\$300-\$300				
\$5,000	491	364	127	322	\$130	192	\$208-300	508	\$98-300	398	0-300-300				
\$6,000	681	534	147	484	284	200	362	-67	429	245-200	445	\$28-200-228			
\$8,000	1,087	905	182	837	608	229	694	456	239	559	294	265	312	0	312
\$10,000	1,482	1,331	151	1,152	948	204	1,010	821	189	867	651	216	586	308	278
\$12,500	1,996	1,816	180	1,573	1,395	177	1,408	1,245	163	1,261	1,114	147	976	766	210
\$15,000	2,549	2,369	180	2,029	1,849	180	1,864	1,684	180	1,699	1,519	180	1,371	1,161	210
\$17,500	3,145	2,965	180	2,516	2,336	180	2,329	2,149	180	2,156	1,976	180	1,827	1,616	210
\$15,000	2,549	2,369	180	2,029	1,849	180	1,864	1,684	180	1,699	1,519	180	1,371	1,161	210
\$17,500	3,145	2,965	180	2,516	2,336	180	2,329	2,149	180	2,156	1,976	180	1,827	1,616	210
\$20,000	3,784	3,604	180	3,035	2,855	180	2,848	2,668	180	2,662	2,480	180	2,285	2,075	210

\$25,000 5,230 5,050 1804,170 3,990 1803,960 3,780 1803,750 3,570
 1803,330 3,120 210

\$30,000 6,850 6,670 1805,468 5,288 1805,228 5,048 1804,988 4,808
 1804,508 4,298 210

\$35,000 8,625 8,445 1806,938 6,758 1806,668 6,488 1806,398 6,218
 1805,858 5,648 210

\$40,000 10,515 10,335 1808,543 8,363 1808,251 8,071 1807,958 7,778
 1807,373 7,163 210

¹ Computed without reference to the tax tables.

² Included the effect of a \$1,700 to \$2,100/16 percent/\$2,400 to \$2,800 standard deduction.

³ Wage or salary and/or self-employment income.

Note: Details may not add to totals because of rounding.

TABLE 4.—INDIVIDUAL INCOME TAX BURDEN ¹ IN 1978 UNDER THE STANDARD DEDUCTION ² OF P.L. 94-455 COMPARED WITH 1974 LAW
 [Single person and married couple with 0, 1, 2, 4, dependents (assuming deductible personal expenses of 17 percent of income)]

Single person	Tax liability												
	Married couple with no dependents			Married couple with 1 dependent			Married couple with 2 dependents			Married couple with 4 dependents			
Adjusted gross income	Under 1974 law	Under P.L. 94-455 Reduction	Under 1974 law	Under P.L. 94-455 Reduction	Under 1974 law	Under P.L. 94-455 Reduction	Under 1974 law	Under P.L. 94-455 Reduction	Under 1974 law	Under P.L. 94-455 Reduction	Under 1974 law	Under P.L. 94-455 Reduction	
\$3,000	\$138	\$78	\$60	\$28	0-\$28	0	0	0	0	0	0	0	0
5,000	491	415	76	322	\$200-122	\$208	\$91-\$117	\$98	0-\$98	0	0	0	0
6,000	681	605	76	484	354-130	362	238-124	245	\$126-119	\$28	0-\$28		
8,000	1,087	1,016	71	837	696-141	694	561-133	559	434-125	312	\$200-112		
10,000	1,482	1,482	01,	1521,	076	-761,	010	934	-76	867	791	-76	586 518 -

12,500	1,9961,996	01,5731,573	01,4081,408	01,2611,261	0 976 976
0					
15,000	2,5492,549	02,0292,029	01,8641,864	01,6991,699	
01,3711,371	0				
17,500	3,1453,145	02,5162,516	02,3292,329	02,1562,156	
01,8261,826	0				
20,000	3,7843,784	03,0353,035	02,8482,848	02,6602,660	
02,2852,285	0				
25,000	5,2305,230	04,1704,170	03,9603,960	03,7503,750	
03,3303,330	0				
30,000	6,8506,850	05,4685,468	05,2285,228	04,9884,988	
04,5084,508	0				
35,000	8,6258,625	06,9386,938	06,6686,668	06,3986,398	
05,8585,858	0				
40,000	10,51510,515	08,5438,543	08,2518,251	07,9587,958	
07,3737,373	0				

¹ Computed without reference to the tax tables.

² \$1,700 or 16 percent of AGI up to \$2,400 for singles and heads of households and \$2,100 or 16 percent of AGI up to \$2,800 for joints.

³ Wage or salary and/or self-employment income.

III. GENERAL EXPLANATION OF THE ACT

A. TAX SHELTER PROVISIONS

1. Real Estate

a. Capitalization and Amortization of Real Property Construction Period Interest and Taxes (sec. 201 of the Act and sec. 189 of the Code)

Prior law

Prior to the Act, amounts paid for interest and taxes attributable to the construction of real property were allowable as current deductions except to the extent the taxpayer elected to capitalize these items as carrying charges (sec. 266).¹ If an election was made to capitalize these items, the amount capitalized was deductible over the useful life of the building. The deduction for taxes (sec. 164) includes sales and real estate taxes paid or accrued on real or personal property during the construction period. The deduction for interest during the construction period includes amounts designated as “points” or loan processing fees so long as these fees were paid by the borrower prior to the receipt of the loan funds and were not paid for specific services.² (Generally, construction period interest is not treated as investment interest for purposes of the limitation on investment interest (sec. 163(d)).³

Reasons for change

Prior to the Act, the tax provisions relating to real estate construction were used by taxpayers in high marginal income tax brackets to avoid payment of income tax on substantial portions of their economic income. This was principally achieved by allowing current deductions for costs which many believe are attributable to later years. For example, during the construction period the interest paid on the construction loan and the real estate taxes were immediately deducted even though there was no income from the property. These deductions resulted in losses which were used by taxpayers to offset income from other sources, such as salary and dividends. In effect, a taxpayer was allowed to defer or postpone the payment of tax on current income, either by offsetting current income with loss deductions attributable to real estate or by receiving a tax-free cash flow from the real estate project, or both. This deferral was the equivalent of an interest-free loan from the government, the economic benefits of which could be very significant.

The allowance of a deduction for construction period interest and taxes is contrary to the fundamental accounting principle of matching income and expenses. Generally, a current expense is deductible in full in the taxable year paid or incurred because it is necessary to produce income and is usually consumed in the process. However, some expenditures are made prior to the receipt of income attributable to the expenditures and, under the matching concept, these expenditures should be treated as a future expense when the income “resulting” from the expenditure is received and the original investment is gradually consumed.

In the case of an individual who constructs a building and subsequently receives income in the form of rents from that building, the accounting concept of matching income against expenses should require that the expenses incurred during the construction period be deducted against the rental income which is received over the life of the building, to the extent the expenses are attributable to a depreciable or wasting asset. The general construction costs of the building are treated this way, being capitalized and subsequently deducted as depreciation expenses. (Similarly, certain pre-opening or start-up expenses for a new trade or business are required to be capitalized for tax accounting purposes.) The interest and taxes paid during the construction period, however, were not capitalized under prior law except to the extent that the taxpayer elected to treat these items as carrying charges chargeable to capital account.

The allowance of a deduction for construction period interest and taxes contributed to the development of tax shelters in the real estate industry. Real estate ventures which were formed primarily to obtain tax shelter benefits essentially represent a misuse of intended tax incentives of longstanding and major importance. In addition, many feel that tax shelters may cause serious distortions in real estate values and construction costs, resulting in investments being made in projects that are economically unsound, and interfering with the efficient allocation of the nation's resources. Although it has been argued that the provisions of prior law providing incentives are essential to attract investment in an industry already suffering from a shortage of capital, the Congress concluded that allowing the full, immediate writeoff of

construction period interest and taxes in these cases was not compatible with the objectives set out above.

As a result of the concern over the tax sheltering in real estate, the Congress decided, after a transition period, to require the capitalization of construction period interest and taxes and provide for the amortization of these items over a 10-year period, which deals directly with the preference providing the shelter while retaining some of the tax incentives for real estate investment by providing a shorter amortization period (10-years) than the useful life of the building.

Explanation of provision.

Under the Act, in the case of a taxpayer other than a corporation which is not a subchapter S corporation or a personal holding company,⁴ real property construction period interest and taxes are to be capitalized in the year in which they are paid or accrued and amortized over a 10-year period. A portion of the amount capitalized may be deducted for the taxable year in which paid or accrued. The balance must be amortized over the remaining years in the amortization period beginning with the year in which the property is ready to be placed in service or is ready to be held for sale.

The prepaid interest rules provided under the Act are to be applied first to determine the period to which the interest relates. If under that provision, interest is treated as allocable to the construction period, the 10-year amortization rule is then to apply to that portion of the interest (in effect, for the purposes of this provision the interest is treated as paid or incurred in the year to which it is allocated under the prepaid interest rules).⁵

Construction period interest includes interest paid or accrued on indebtedness incurred or continued to acquire, construct, or carry real property to the extent attributable to the construction period for such property. The construction period commences with the date on which the construction of a building or other improvement begins and ends on the date that the building or improvement is ready to be placed in service or is ready to be held for sale. For this purpose, the construction period is not to be considered to have commenced solely because drilling is performed to determine soil conditions, architect's sketches or plans are prepared, or a building permit is obtained. Generally the construction period will be considered to have commenced when land preparations and improvements, such as clearing, grading, excavation, and filling, are undertaken. However, the construction period will not be considered to have commenced solely because clearing or grading work is undertaken, or drainage ditches are dug, if such work is undertaken primarily for the maintenance or preservation of raw land and existing structures and is not an integral part of a plan for the construction of new or substantially renovated buildings and improvements. In the case of the demolition of existing structures where the construction period has not otherwise commenced, the construction period is considered to commence when demolition begins if the demolition is undertaken to prepare the site for construction. The construction period will not be considered to commence solely because of the demolition of existing structures if the demolition is not undertaken as part of a plan for the construction of new or substantially renovated buildings or improvements.⁶

The provision is not to apply to any amount that is capitalized at the election of the taxpayer as a carrying charge (sec. 266). In addition, the provision is not to apply to interest or taxes paid or accrued with respect to property that is not held (or will not be held) for business or investment purposes (e.g., the taxpayer's residence).

Separate transitional rules are provided for non-residential real estate, residential real estate, and government-subsidized housing. In the case of nonresidential real estate, this provision is to apply to property where the construction period begins after December 31, 1975, with respect to amounts paid or accrued in taxable years beginning after 1975. In the case of residential real estate (other than certain low-income housing), this provision is to apply to construction period interest and taxes paid or accrued in taxable years beginning after December 31, 1977, and, in the case of low-income housing, to construction

period interest and taxes paid or accrued in taxable years beginning after December 31, 1981. For this purpose, low-income housing means government housing entitled to the special rules relating to recapture of depreciation (under sec. 1250(a)(1)(B)).

In addition, the length of the amortization period is to be phased-in over a 7-year period. The amortization period is to be 4 years in the case of interest and taxes paid or accrued in the first year to which these rules apply. The amortization period increases by one year for each succeeding year after the initial effective date until the amortization period becomes 10 years (i.e., the 10-year period is fully phased-in for construction period interest and taxes paid or accrued in taxable years beginning in 1982, in the case of non-residential real estate; 1984, in the case of residential real estate; and 1988, in the case of government subsidized low-income housing). As a special transition rule for 1976 only, 50 percent of the amount paid or incurred may be deducted currently but, the remaining 50 percent is to be amortized over a 3-year period beginning in the year the property is ready to be placed in service or is ready to be held for sale.

The application of the general transitional rules and the phase-in of the amortization period can be illustrated by the following example. Assume that \$120,000 of interest and taxes are paid or accrued in 1980 with respect to the construction of residential real estate (other than government subsidized low-income housing) and that the property is ready to be placed in service in 1982. For taxable year 1980, the \$120,000 must be capitalized under this provision, but a deduction is to be allowed for \$20,000 (1/6 of the amount capitalized). The remaining \$100,000 (i.e., 5/6 of the total) is to be deducted ratably over a 5-year period beginning in 1982 (the year in which the property is ready to be placed in service). Thus, \$20,000 is to be allowed as a deduction for taxable year 1982 and in each of the next succeeding 4 years.

In the case of a sale or exchange of real property, the unamortized balance of the construction period interest and taxes is to be added to the basis of the property for purposes of determining gain or loss on the sale or exchange. In the case of nontaxable transfer or exchange (i.e., a transfer to a partnership or controlled corporation, a like-kind exchange, or a gift), the transferor is to continue to deduct the unamortized balance allowable over the amortization period remaining after the transfer.

Effective date

In the case of nonresidential real estate, this provision is to apply only to property where the construction period begins after December 31, 1975, and only with respect to amounts paid or accrued in taxable years beginning after 1975. In the case of residential real estate (other than certain low-income housing), this provision is to apply to construction period interest and taxes paid or accrued in taxable years beginning after December 31, 1977, and, in the case of low-income housing to construction period interest and taxes paid or accrued in taxable years beginning after December 31, 1981. In each of these cases, phase-in rules of the amortization period are provided, as indicated above.

Revenue effect

The revenue gain from this provision is estimated to be \$102 million for fiscal year 1977 and \$149 million for fiscal year 1981.

b. Recapture of Depreciation on Real Property (sec. 202 of the Act and sec. 1250 of the Code)

Prior law

Generally, net gains on the sale of real property used in a trade or business (with certain exceptions) are taxed as capital gains, and losses are generally treated as ordinary losses. However, gain on the sale of depreciable real property (buildings) is generally “recaptured” and taxed as ordinary income rather than capital gain to the extent that the gain represents accelerated depreciation allowed or allowable in excess of the amount computed under the straight-line method of depreciation.

The provisions relating to depreciation recapture were first enacted in 1962 to prevent deductions for accelerated depreciation from converting ordinary income into capital gain. In general, the 1962 recapture provision (sec. 1245 of the code) provided that gain on a sale of most personal property would be taxed as ordinary income to the extent of all depreciation taken on the property after December 31, 1962. In 1964, recapture rules were extended to real property (buildings) to provide, in general, that gain on a sale would be taxed as ordinary income to the extent of the depreciation (in most cases only the accelerated depreciation) taken on that property after December 31, 1963. This provision (sec. 1250 of the code), however, had a gradual reduction of the amount to be recaptured. If the property had not been held for more than 12 months, all of the depreciation was recaptured. However, if the property had been held over 12 months, only the excess depreciation over straight-line was recaptured and the amount recaptured was reduced after an initial 20-month holding period at the rate of one percent per month. Thus, after 120 months (10 years) there was no recapture of any depreciation.

In the Tax Reform Act of 1969, the recapture rules on real property were further modified as to post-1969 depreciation. In the case of residential real property and property with respect to which the rapid depreciation for rehabilitation expenditures has been allowed, post-1969 depreciation in excess of straight-line was fully recaptured at ordinary income rates (to the extent of gain) if the property has been held for more than 12 months⁷ but less than 100 months (8 years and 4 months). For each month the property was held over 100 months, there was a one percent reduction in the amount of post-1969 depreciation that was recaptured. Thus, there was no recapture of any depreciation if the property was held for 200 months (16 years and 8 months).

In the case of non-residential real property, all post-1969 depreciation in excess of straight-line depreciation is recaptured (to the extent there is gain) regardless of the length of time the property is held.

In addition, in the case of certain Federal, State, and locally assisted housing projects constructed, reconstructed, or acquired before January 1, 1976, such as the FHA 221(d)(3) and the FHA 236 programs, the pre-1969 recapture rules on real property were retained.⁸ However, if the property was constructed, reconstructed, or acquired after December 31, 1975, the regular post-1969 rules previously discussed above with respect to residential property were to apply (i.e., a one percent reduction per month after 100 months).

Reasons for change

Generally, deductions for accelerated depreciation exceed the actual decline in the usefulness of the property. Further, accelerated methods of depreciation make it possible for taxpayers to deduct amounts in excess of the those required to service the mortgage during the early life of the property.

When the property is sold, the excess of the sales price over the adjusted basis was treated as capital gain to the extent that the recapture provisions did not apply. Under prior law, by holding residential rental property for 16 ²/₃ years before sale, the taxpayer could arrange to have all gain resulting from excess depreciation (which was previously offset against ordinary income) taxed at the capital gain rates without any recapture.⁹ The tax advantages for converting ordinary income into capital gain increase as the

taxpayer's marginal income tax rate increases.

To reduce the opportunities to avoid income taxes as a result of allowing accelerated depreciation for real property to convert ordinary income into capital gain, the Congress decided that it is appropriate to extend the application of the present recapture rules on residential real estate. Under the Act, when residential real estate is sold, any gain will be recognized as ordinary income to the extent of accelerated depreciation previously allowed or allowable. In the case of low-income housing, however, the Congress decided that it is not desirable to require full recapture. In this way, an incentive is provided for owners of such housing to retain their ownership and operation of the properties for longer periods of time.

In addition, it came to the attention of the Congress that certain taxpayers have taken dilatory action to postpone foreclosure (or similar proceedings) on real property for the principal purpose of reducing the applicable percentage of accelerated depreciation that will be recaptured upon foreclosure (or similar proceeding). As a result of this, the Congress decided to make the recapture rules apply in the case of real property from the date foreclosure proceedings are commenced.

Explanation of provision

In the case of residential real estate (other than certain low-income rental housing), the Act provides for the complete recapture of all post-1975 depreciation in excess of straight-line depreciation. (This rule already applies in the case of nonresidential, i.e., commercial property.) As under prior law, all of the depreciation taken, including straight-line depreciation, is recaptured as ordinary income if the property is not held for more than 12 months. Under the Act, all accelerated depreciation (depreciation in excess of straight-line) attributable to periods after December 31, 1975, will be fully recaptured to the extent of any depreciation in excess of straight-line regardless of the date the property was constructed. Special rules are provided in the case where a portion of the gain from the sale or exchange of property is subject to recapture under both the former recapture rules and the new recapture rules. Under these special rules, first, accelerated special rules, first, accelerated depreciation attributable to periods after December 31, 1975, will be recaptured (to the extent of any gain); second, accelerated depreciation attributable to periods after December 31, 1969, and before January 1, 1976, will be recaptured (to the extent of any additional gain not recaptured under the new rules); and third, accelerated depreciation attributable to periods after December 31, 1963, and before January 1, 1970 (to the extent of any remaining gain not recaptured).

The new rules providing for complete recapture of accelerated depreciation do not apply to 4 categories of low-income rental housing: (1) Federally assisted housing projects with respect to which a mortgage is insured under section 221(d)(3) or 236 of the National Housing Act (or housing financed or assisted by direct loan or tax abatement under similar provisions of State or local laws); (2) low-income rental housing held for occupancy by families or individuals eligible to receive subsidies under section 8 of the United States Housing Act of 1937, as amended, or under the provisions of State or local law authorizing similar levels of subsidy for lower income families; (3) low-income rental housing with respect to which a depreciation deduction for rehabilitation expenditures was allowed under section 167(k); and (4) Federally assisted housing with respect to which a loan is made or insured under title V of the Housing Act of 1949. As to these 4 categories of real property, all depreciation will be recaptured if the property has not been held for more than 12 months. However, if the property has been held for more than 12 months, no more than the excess depreciation over straight-time will be recaptured. For each month the property is held over 100 months, there will be a one percent per month reduction in the amount of accelerated depreciation attributable to periods after December 31, 1975, which is recaptured. Thus, after 200 months (16 2/3 years) there will be no recapture.

Special rules similar to those discussed above are provided for Federally assisted housing projects with respect to which a mortgage is insured under section 221(d)(3) or 236 of the National Housing Act (or housing financed or assisted by direct loan or tax abatement under similar provisions of State or local laws)

where a portion of the gain from the sale or exchange of such property is subject to recapture under both the prior recapture rules and the new recapture rules.

In addition, the Act provides that where real property is disposed of by reason of foreclosure or similar proceedings, the monthly percentage reduction of the amount of accelerated depreciation subject to recapture are to terminate as of the date on which such proceedings were begun. The application of this provision can be illustrated by the following example:

Example. —Assume that on June 1, 1976, the taxpayer acquired certain low-income rental property which qualified for the special recapture treatment discussed above (i.e., a one percent per month reduction after 100 months). On April 1, 1987 (130 months after the property was placed in service) foreclosure proceedings were instituted with respect to the property and on December 1, 1988 (150 months after the property was placed in service) the property was disposed of pursuant to the foreclosure proceedings. The applicable percentage reduction will be 30 percent rather than 50 percent since the percentage reduction would cease to apply on April 1, 1987 (the date that foreclosure proceedings were instituted).

Effective date

The provisions relating to the complete recapture of depreciation apply to accelerated depreciation attributable to taxable years beginning after December 31, 1975. The provisions relating to the percentage reduction in the case of dispositions pursuant to foreclosure or similar proceedings shall apply with respect to proceedings which begin after December 31, 1975.

Revenue effect

It is estimated that this provision will result in an increase in budget receipts of \$9 million for fiscal year 1977, and \$56 million for 1981.

c. Five-Year Amortization for Low-Income Rental Housing (sec. 203 of the Act and sec. 167 of the Code)

Prior law

Under the code, special depreciation rules are provided for expenditures to rehabilitate low income rental housing (sec. 167(k) of the code). Low-income rental housing includes buildings or other structures that are used to provide living accommodations for families and individuals of low or moderate income. Under current Treasury regulations occupants of a dwelling unit are considered families and individuals of low or moderate income only if their adjusted income does not exceed 90 percent of the income limits described by the Secretary of Housing and Urban Development (HUD) for occupants of projects financed with certain mortgages insured by the Federal Government. The level of eligible income varies according to geographical area.¹⁰

Under the special depreciation rules for low income rental property, taxpayers can elect to compute depreciation on certain rehabilitation expenditures under a straight-line method over a period of 60 months if the additions or improvements have a useful life of 5 years or more. Under prior law, only the aggregate

rehabilitation expenditures as to any housing which do not exceed \$15,000 per dwelling unit qualified for the 60-month depreciation. In addition, for the 60-month depreciation to be available, the sum of the rehabilitation expenditures for two consecutive taxable years—including the taxable year—must exceed \$3,000 per dwelling unit.

Reasons for change

In the Housing and Community Development Act of 1974, the Congress expressed its desire to stimulate construction in low-income rental housing to eliminate the shortage in the area. However, the special tax incentive for rehabilitation expenditures for low-income rental housing under present law expired on December 31, 1975. Without this incentive the remodeling of many high-risk low-income projects would have been curtailed. In order to avoid discouraging this rehabilitation, the Congress believed that the special depreciation provision for low-income housing should be extended.

Explanation of provision

The Act provides a two-year extension of the special 5-year depreciation rule for expenditures to rehabilitate low-income rental housing and increases the amount of rehabilitation expenditures that can be taken into account per dwelling unit from \$15,000 to \$20,000.

Under the Act, rehabilitation expenditures that are made pursuant to a binding contract entered into before January 1, 1978, would qualify for the 5-year depreciation rule even though the expenditures are actually made after December 31, 1977.

In addition, the Act modifies the definition of families and individuals of low and moderate income by providing that the eligible income limits are to be determined in a manner consistent with those presently established for the Leased Housing Program under Section 8 of the United States Housing Act of 1937, as amended.

Effective date

The provisions relating to the 2-year extension apply to expenditures paid or incurred with respect to low-income rental housing after December 31, 1975, and before January 1, 1978 (including expenditures made pursuant to a binding contract entered into before January 1, 1978). The provisions increasing the amount of expenditures that can be depreciated under the special 5-year rule apply to expenditures incurred after December 31, 1975.

Revenue effect

It is estimated that the provision will result in a decrease in budget receipts of \$1 million for fiscal year 1977, and \$7 million for 1981.

2. Limitation of Loss to Amount At-Risk (sec. 204 of the Act and sec. 465 of the Code)

Prior law

Generally, the amount of depreciation or other deductions which a taxpayer has been permitted to take in connection with a property has been limited to the amount of his basis in the property. Similar statutory limitation rules are found in sections 704(d) and 1374(c)(2) for owners of partnership interests and shareholders in subchapter S corporations where the partners and shareholders, rather than the entity, are taxed on the income or loss of the entity.

The starting point for determining a taxpayer's adjusted basis in a productive activity or enterprise is generally the taxpayer's cost for the assets used in the activity or enterprise (secs. 1011, 1012). In the case of a productive activity engaged in through a partnership or subchapter S corporation, the investor's adjusted basis in his stock or partnership interest is generally based on the amount of money and his adjusted basis in other property contributed to the enterprise (secs. 722, 358). The investor's basis in a partnership interest or subchapter S corporation stock is increased by his portion of the income of these entities, and decreased by his portion of their losses, in recognition of the fact that the income and losses are flowed through to the investor for tax purposes, rather than being taxed to the entity.

The liabilities of a productive activity may also have an effect upon an investor's adjusted basis in the activity. Thus, a taxpayer's basis in a property includes the portion of the purchase price which is financed even if the taxpayer is not personally liable on the loan and the lender must look solely to the financed property for repayment of the loan.

However, in the case of a subchapter S corporation, liabilities of the corporation increase a shareholder's adjusted basis in the stock only to the extent that the liability is owed to that particular shareholder (secs. 1374(c)(2), 1376).

In the case of partnerships, in general, a partner's share of the liabilities of the partnership is considered to be a contribution of money by him to the partnership (sec. 752). Since a partner's contributions to the partnership increase the adjusted basis of his partnership interest (sec. 705), the partner's adjusted basis reflects not only his contributions in money and other property, but also his share of partnership liabilities. This rule applies regardless of whether the particular liability is owed to one or more of the partners or to an unrelated party.

The rule is premised upon the assumption that the partner may be held personally liable for the debts of the partnership and since he may be called on to, in effect, make additional contributions of money to cover these liabilities, the adjusted basis of his partnership interest should reflect this potential risk of additional liability.

However, a limited partner in a limited partnership may not be held responsible for partnership debts, and his potential personal liability is confined to any additional amount he is required to contribute to the partnership by the partnership agreement. Since a limited partner does not have unlimited personal liability, the basis of his partnership interest is not usually increased to reflect borrowing by the partnership. There has been, however, an exception to this rule. The regulations provide that where none of the partners have personal liability for a partnership obligation, all of the partners, including limited partners share in the liability (Reg. §1.752-1(e)). Since a limited partner is deemed to have a share of such nonrecourse liabilities, the adjusted basis of his partnership interest is increased under the generally applicable partnership provisions.

This approach to nonrecourse partnership liabilities arose from a judicially developed principle known as the *Crane* rule. The *Crane* rule was derived from the Supreme Court's reasoning in *Crane v.*

Commissioner, 331 U.S. 1 (1947), where it was held that an owner's adjusted basis in a parcel of real property included the amount of a nonrecourse mortgage on the property, under which the mortgagee-lender could seek a recovery of its loan only from the property. (It is because of the *Crane* rule that nonrecourse indebtedness has generally been included in an investor's adjusted basis, as indicated above, in a business or productive property.)

Also, in general, the existence of protection against ultimate loss by reason of a stop-loss order, guarantee, guaranteed repurchase agreement or similar arrangement does not generally impose a limitation on the amount of losses a taxpayer may deduct in the early taxable years of an activity.

Reasons for change

The typical tax shelter has operated as a limited partnership with individual investors participating as limited partners. Virtually all of the equity capital for the activity has been contributed by the limited partners with the major portion of the remaining operating funds (generally 75 percent or more of the total capital) for the partnership financed through nonrecourse loans.

When an investment had been solicited for a tax shelter activity, it had been common practice to promise the prospective investor substantial tax losses which could be used to decrease the tax on his income from other sources. The opportunity to deduct tax losses in excess of the amount of the taxpayer's economic risk had arisen under prior law primarily through the use of nonrecourse financing not only by limited partnerships, but also by individuals and subchapter S corporations. The ability to deduct tax losses in excess of economic risk had also arisen through guarantees, stop-loss agreements, guaranteed repurchase agreements, and other devices used by the partnerships, individuals and subchapter S corporations.

Nonrecourse leveraging of investments and other risk limiting devices which produce tax savings in excess of amounts placed at risk substantially alter the economic substance of the investments and distort the workings of the investment markets. Taxpayers, ignoring the possible tax consequences in later years, can be led into investments which are otherwise economically unsound and which constitute an unproductive use of investment funds.

Congress believed that it was not equitable to allow individual investors to defer tax on income from other sources through losses generated by tax sheltering activities. One of the most significant problems in tax shelters was the use of nonrecourse financing and other risk-limiting devices which enabled investors in these activities to deduct losses from the activities in amounts which exceeded the total investment the investor actually placed at risk in the activity. The Act consequently provides an "at risk" rule to deal directly with this abuse in tax shelters.

Explanation of provision

To prevent a situation where the taxpayer may deduct a loss in excess of his economic investment in certain types of tax shelter activities, the Act provides that the amount of any loss (otherwise allowable for the year) which may be deducted in connection with one of these activities cannot exceed the aggregate amount with respect to which the taxpayer is at risk in each such activity at the close of the taxable year. This "at risk" limitation applies to the following activities: (1) farming¹; (2) exploring for, or exploiting, oil and gas resources; (3) the holding, producing, or distributing of motion picture films or video tapes; and (4) equipment leasing. The limitation applies to all taxpayers (other than corporations which are not subchapter S corporations or personal holding companies) including individuals and sole proprietorships, estates, trusts, shareholders in subchapter S corporations, and partners in a partnership which conducts an

activity described in this provision.²

The at risk limitation is to apply on the basis of the facts existing at the end of each taxable year. The at risk limitation applies regardless of the method of accounting used by the taxpayer and regardless of the kind of deductible expenses which contributed to the loss.

The amount of any loss which is allowable in a particular year reduces the taxpayer's at risk amount as of the end of that year and in all succeeding taxable years with respect to that activity.³

Losses which are suspended under this provision with respect to a taxpayer because they are greater than the taxpayer's investment which is "at risk" are to be treated as a deduction with respect to the activity in the following year. Consequently, if a taxpayer's amount at risk increases in later years, he will be able to obtain the benefit of previously suspended losses to the extent that such increases in his amount at risk exceed his losses in later years.

The at risk limitation is only intended to limit the extent to which certain losses in connection with the covered activities may be deducted in the year they would otherwise be allowable to the taxpayer. The rules of this provision do not apply for other purposes, such as the determination of basis. Thus, a partner's basis in his interest in the partnership will generally be unaffected by this provision of the committee amendment.⁴ However, for purposes of determining how much, if any, of his share of a partnership loss from the enumerated activities a partner may deduct in any year, this provision of the Act overrides the existing partnership rules of section 704(d) and related provisions, including regulations section 1.752-1(e).⁵

For purposes of this provision, a taxpayer is generally to be considered "at risk" with respect to an activity to the extent of his cash and the adjusted basis of other property contributed to the activity, as well as any amounts borrowed for use in the activity with respect to which the taxpayer has personal liability for payment from his personal assets.

A taxpayer's at risk amount is also generally to include amounts borrowed for use in the activity which are secured by property other than property used in the activity. For example, if the taxpayer acting as a sole proprietor (or partner or shareholder in a subchapter S corporation) uses personally-owned real estate to secure nonrecourse indebtedness, the proceeds from which are used in an equipment leasing activity, the proceeds may be considered part of the taxpayer's at risk amount. In such a case, the portion of the proceeds which increases the taxpayer's at risk amount is to be limited by the fair market value of the property used as collateral (determined as of the date the property is pledged as security), less any prior (or superior) claims to which the collateral is subject.

The Act contains a special rule which prevents a taxpayer from increasing his at risk amount through collateral in cases where the collateral was financed directly or indirectly by indebtedness which is secured by any property used in the activity. The intent of this rule is to prevent a taxpayer from increasing his at risk amount by cross-collateralizing property used in the activity with other property not used in the activity.

Except where the indebtedness is secured by property not used in the activity, a taxpayer is not to be considered at risk with respect to the proceeds from his share of any nonrecourse loan used to finance the activity or the acquisition of property used in the activity. In addition, if the taxpayer borrows money to contribute to the activity and the lender's only recourse is either the taxpayer's interest in the activity or property used in the activity, the amount of the proceeds of the borrowing are to be considered amounts financed on a nonrecourse basis and do not increase the taxpayer's amount at risk.

Also, under these rules, a taxpayer is not to be "at risk," even as to the equity capital which he has contributed to the activity, to the extent he is protected against economic loss of all or part of such capital by reason of an agreement or arrangement for compensation or reimbursement to him of any loss which he

may suffer.⁶ Under this concept, a taxpayer is not “at risk” if he arranges to receive insurance or other compensation for an economic loss after the loss is sustained, or if he is entitled to reimbursement for part or all of any loss by reason of a binding agreement between himself and another person.⁷

Similarly, if a taxpayer is personally liable on a mortgage but separately obtains insurance to compensate him for any payments which he must actually make under such personal liability, the taxpayer is at risk only to the extent of the uninsured portion of the personal liability to which he is exposed.⁸ The taxpayer will be able to include in the amount which he has at risk any amount of nondeductible premium which he has paid from his personal assets with respect to the insurance. However, a taxpayer who obtains casualty insurance or insurance protecting himself against tort liability will not be considered “not at risk” solely because of such hazard insurance protection.

In the case of a partnership, a partner is generally to be treated as at risk to the extent that his basis in the partnership is increased by his share of partnership income.⁹ The fact that partnership income is then used to reduce the partnership's nonrecourse indebtedness would have no effect on the partner's amount at risk. (The reduction of nonrecourse indebtedness would still, of course, reduce his basis in his partnership interest for purposes other than the at risk limitation.)¹⁰ If the partnership, instead of retaining the income, makes actual distributions of the income to a partner in the taxable year, the amount distributed, like any cash distribution, reduces the partner's amount at risk.

In general, in the case of an activity engaged in by an individual, each motion picture film or video tape, item of leased equipment, farm, or oil and gas property is treated as a separate activity. However, in the case of a partnership, personal holding company, or subchapter S corporation, all of the activities of the same type (e.g., all motion picture films and video tapes) are to be treated as one activity.¹¹ Thus, where the partnership is engaged in only one type of activity the loss from the activity for any partner is that partner's loss from the partnership and (assuming no stop loss orders, etc.) his at risk amount is generally the amount of his cash or other contribution to the partnership, plus his share of any indebtedness with respect to which the partner has no limitation on liability.

The at risk limitation applies only to losses produced by deductions which are not disallowed by reason of some other provision of the Code. For example, if a prepaid interest expense is suspended under the prepaid interest limitation (sec. 208 of the Act and sec. 461 of the Code) that expense will not enter into the computation of the loss subject to the at-risk limitation. When the interest accrues and becomes deductible, the expense may at that time be subject to this provision. Similarly, if a deduction is deferred pursuant to the farming syndicate rules (described below), that deduction will enter into the computation of the tax loss subject to the at risk limitation only when it becomes deductible under the farming syndicate rules.

The Act specifically requires that a taxpayer not be considered at risk with respect to amounts borrowed for use in an activity (or which are contributed to the activity)¹² where the amounts are borrowed from any person who has an interest in the activity (other than that as a creditor) or who is related to the taxpayer (as described in sec. 267(b)). Persons having an interest in the activity include, in the case of a partnership, all other partners and any other person (such as a promoter or selling agent) who stands to receive financial gain from the activity or from the sale of interests in the activity. Those persons considered to be related to the taxpayer include the taxpayer's spouse, ancestors and lineal descendants, brothers and sisters, and corporations and other entities in which the taxpayer has a 50-percent or greater interest.¹³

Effective dates

In general, the at risk provision applies to losses attributable to amounts paid or incurred (and depreciation or amortization allowed or allowable) in taxable years beginning after December 31, 1975. However, with respect to equipment leasing activities, the at risk rule generally does not apply where the property was subject to a net operating lease and binding contracts were finalized on or before December 31, 1975, and

similarly to operating lease transactions under binding contracts finalized on or before April 30, 1976.

With respect to motion picture activities, the at risk provision does not apply to a film purchase shelter if the principal photography began before September 11, 1975, there was a binding written contract for the purchase of the film on that date, and the taxpayer held his interest in the film on that date. The at risk rule also does not apply to production costs, etc., if the principal photography began before September 11, 1975, and the investor had acquired his interest in the film before that date. In addition, the at risk provision does not apply to film produced in the United States if the principal photography began before January 1, 1976, if certain commitments with respect to the film had been made by September 10, 1975.

In applying the at risk provisions to activities which were begun in taxable years beginning before January 1, 1976 (and not exempted from this provision by the above transition rules), amounts paid or incurred in taxable years beginning prior to that date and deducted in such taxable years will generally be treated as reducing first that portion of the taxpayer's basis which is attributable to amounts not at risk. (On the other hand, withdrawals made in taxable years beginning before January 1, 1976, will be treated as reducing the amount which the taxpayer is at risk.)¹⁴

Revenue effect

The provision will increase budget receipts by \$57 million in fiscal year 1977, \$42 million in fiscal year 1978, and \$38 million in fiscal year 1981.

3. Farm Operations

a. Farming Syndicates (sec. 207(a) and (b) of the Act and secs. 278 and 464 of the Code)

Prior law

Under the tax laws, farm operations are governed by special tax rules, many of which confer tax benefits on farming activities and on persons who engage in farming. The special tax rules available to farmers have been utilized by both full-time farmers and by high-bracket taxpayers who participated in farming as a sideline. Part-time farmers have been entitled to use the special farm rules even if they were absentee owners who paid agents to operate their farming activities and regarded their own participation (such as being limited partners in a nationwide syndicate) as a completely passive investment.

Taxpayers engaged in farming have been allowed to report their income and expenses from farm operations on the cash method of accounting, which does not require the accumulation of inventory costs. Farmers have also been allowed to deduct the cost of seed and young plants purchased in one year which would be sold as farm products in a later year.¹ These rules contrast with the tax rules applicable to nonfarm taxpayers engaged in the business of selling products, who must report their income using the accrual method of accounting and must accumulate their production costs in inventory until the product is sold.

The special inventory exception for farmers was adopted by administrative regulation more than fifty years ago. The primary justification for this exception was the relative simplicity of the cash method of

accounting which, for example, eliminates the need to identify specific costs incurred in raising particular animals.

The Treasury has also long permitted farmers to deduct currently many of the costs of raising or growing farm assets (such as costs related to breeding animals, orchards and vineyards) which are used in the trade or business of farming.² (In similar nonfarming businesses, such as manufacturing, these costs generally are treated as capital expenditures and are depreciated over their useful lives.) These assets are used in a taxpayer's business and may eventually be sold at a gain which is taxed at the lower capital gain tax rate. Since development costs could be deducted before the income is realized from the sale of livestock or crops, the development costs would offset a farm investor's income from other sources such as salaries, interest, professional fees, etc.

Certain other statutory provisions allow specific types of capital improvements to farmland to be deducted when the taxpayer pays them. These costs include soil or water conservation expenditures (sec. 175), fertilizer costs (sec. 180), and land clearing expenses (sec. 182). Similar capital expenditures in a nonfarm business would be added to the basis of the property and, since land is nondepreciable, could be recovered only out of the proceeds when the land is sold.

Capital gain treatment is generally available on the sale of depreciable assets used in farming (as well as on the sale of the underlying farmland itself), even though these assets or land may have been developed or improved by expenditures which were deducted against ordinary income.³ In effect, a farm investor's income which has been initially sheltered by accelerated farm deductions has been transformed into added capital value of the farm asset and taxed as part of that value when the farm capital assets (vineyard, breeding animal, farmland, etc.) are later sold.

After breeding animals, vineyards or orchards reach maturity and are held for the production of annual crops, farmers and farm investors continue to receive tax benefits through deductions for accelerated depreciation.⁴ Capital gain treatment on the sale of farm assets held for the production of income or used in a taxpayer's farm business is not available to the extent that various recapture rules of present law are applicable. For example, section 1251 requires a limited recapture as ordinary income (rather than capital gain) of previous farm tax losses whenever assets used in a farming business are sold or disposed of. (This section of prior law was amended by section 206 of the Act.)

Section 1252 recaptures amounts previously deducted as soil and water conservation and land clearing expenses if farmland is sold within 5 years after acquisition. If the land is held for a longer period, the amount recaptured is reduced by 20 percent for each year over 5 years that the property is held. Thus, if the land is held more than 10 years, no recapture is required on a sale of farmland.

The holding period for long-term capital gain treatment of cattle and horses held for draft, breeding, dairy, or sporting purposes (such as horse racing) is 24 months (sec. 1231(b)(3)). The minimum holding period for other livestock held for such purposes is 12 months. (One effect of this rule is that many sales of "culls" from a breeding herd, i.e., animals regarded as unsuitable, are taxable at ordinary income rates, since many culls are sold within 24 months.)⁵

Section 183 limits the current deduction of expenses in an activity which a taxpayer conducts other than "for profit." Although not limited to farming, this provision may affect a variety of farm operations. If an activity is found not to be engaged in for profit, expenses can be deducted only to the extent that income derived from the activity exceeds deductible interest, taxes and casualty losses.

Reasons for change

Farm investments have offered an opportunity to defer taxes on nonfarm income where investors were able

to take advantage of the special farm tax rules to deduct farm expenses in a year or years prior to the years when the revenue associated with such expenses was earned. This type of deferral could occur regardless of whether the proceeds from the later sale of the underlying products were taxed at ordinary income or capital gain rates. Generally, in farming operations tax losses were shown in early years of an investment because of (1) the opportunity to deduct, when paid, costs which in nonfarm businesses would be inventoried and deducted in a later year, (2) the ability to deduct, when paid, costs which under general accounting principles should have been capitalized, and (3) the ability to claim depreciation deductions which exceeded straight-line depreciation.

These tax losses were used to offset income from a taxpayer's other nonfarm occupations or investments on which he would otherwise have been required to pay tax currently. When the income which was related to these deductions was reported, it was not reduced by the amount of the deductions attributable to it (and was thus greater in net amount than it otherwise would be). This lack of matching resulted in deferral of taxes from the years when the initial deductions were taken. If the related farm income was eventually realized as capital gain (as it might have been where breeding animals or orchards were sold), conversion of ordinary income (against which the expenses were deducted) into capital gain also resulted. Even without the possibility of conversion, however, the tax advantages of deferral alone were frequently sufficient to motivate high-income taxpayers to engage in certain types of farming activities.

Even after the Tax Reform Act of 1969, high-bracket taxpayers continued to use farm tax rules to shelter nonfarm income because (except for citrus and almond groves) the restrictions in prior law did not prevent the initial deferral of taxes on nonfarm income by means of accelerated deductions incurred in farm activities. Prior law focused largely on recapturing deductions which otherwise would be used to convert ordinary income into capital gain, and on limiting capital gain treatment by increasing the holding periods for farm assets. However, under the cash method of accounting, farm expenses are still deductible as they are paid. The time value of deferring taxes on nonfarm income remained a strong attraction for outside investors to invest in farming and to use as much borrowed money as possible to create farm "tax losses."

Since 1969, the number and volume of publicly syndicated investments in almost all areas of agriculture increased substantially. Farm tax benefits were effectively packaged and sold to high-bracket taxpayers through limited partnerships (and management contracts) for investments in cattle feeding and breeding, tree crops, vegetable and other field crops, vineyards, dairy cows, fish, chickens, and egg production.

Table 1 sets forth the average farm loss reported for tax purposes since 1969 by individual taxpayers in different income brackets. This table shows that average farm losses increased as taxpayers' income levels increased, and that this trend remained consistent during the four years covered by the table. The fact that the largest farm losses were concentrated in income levels over \$100,000 suggests that high-bracket taxpayers continued to make use of the special farm tax rules to shelter their nonfarm income.

TABLE 1. —NET FARM LOSSES BY SIZE OF ADJUSTED GROSS INCOME

Adjusted gross income	1970		1971	
	Returns showing farm loss	Average farm loss	Returns showing farm loss	Average farm loss
All returns --total	1, 234, 092	(\$2, 350)	1, 290, 203	(\$2, 540)
Total net farm loss (thousands)	(2, 899, 513)		(3, 277, 548)	

Under \$5,000	485, 531	(2, 659)	475, 983	(2, 969)
\$5,000 under \$10,000	379, 947	(1, 576)	385, 338	(1, 664)
\$10,000 under \$20,000	284, 652	(1, 669)	327, 808	(1, 822)
\$20,000 under \$50,000	63, 949	(4, 202)	78, 358	(4, 087)
\$50,000 under \$100,000	14, 697	(9, 473)	16, 575	(9, 527)
\$100,000 under \$500,000	5, 012	(21, 016)	5, 787	(20, 903)
\$500,000 under \$1,000,000	210	(43, 143)	252	(52, 516)
\$1,000,000 or more	94	(128, 149)	102	(134, 069)

	1972		1973	
Adjusted gross income	Returns showing farm loss	Average farm loss	Returns showing farm loss	Average farm loss
All returns --total	1, 171, 591	(\$2, 758)	1, 218, 962	(\$3, 343)
Total net farm loss (thousands)	(3, 230, 956)		(4, 074, 998)	
Under \$5,000	363, 492	(3, 821)	371, 489	(4, 323)
\$5,000 under \$10,000	325, 492	(1, 879)	290, 056	(2, 365)
\$10,000 under \$20,000	354, 754	(1, 852)	397, 588	(2, 123)
\$20,000 under \$50,000	100, 840	(3, 894)	126, 567	(3, 907)
\$50,000 under \$100,000	19, 642	(9, 607)	24, 494	(8, 970)

\$100,000 under \$500,000	6, 941	(21, 784)	8, 390	(23, 108)
\$500,000 under \$1,000,000	301	(50, 296)	268	(70, 451)
\$1,000,000 or more	129	(170, 418)	110	(110, 018)

Source: U.S. Treasury Department, *Statistics of Income -- Individual Income Tax Returns*, 1970, 1971, 1972, 1973 (preliminary).

Deferral shelters. —Some of the more popular types of farming operations which have been used as deferral shelters are set out below.

Cattle feeding has offered one of the best known and, until recent downturns in the farm economy, most widely used deferral shelters. Typically, the investment has been organized as a limited partnership or as an agency relationship (under a management contract) in which a commercial feedlot or a promoter has agreed to act as an agent for the investor in buying, feeding and managing cattle. After being fed a specialized diet for four to six months, the fattened cattle were sold at public auction to meat packers or food companies. A cattle feeding venture of this kind has typically been formed in November or December, using leveraging and the cash method of accounting to permit taxpayers with income from other sources to defer taxes otherwise due on that income in that year by deducting expenses for prepaid feed, interest, and other costs incurred in the feeding venture. Income was realized in the following year when the fattened cattle were sold. At that time, the bank loans were repaid and any unpaid fees due the feedlot (or promoter) were deducted. The balance was distributed to the investors. Since feeder cattle are held for sale to customers, sales of the animals produce ordinary income. If the investors were to reinvest their profit from one feeding cycle into another one, they could theoretically defer taxes indefinitely on the nonfarm income which they sheltered originally.

Since most investors in cattle feeding shelters have typically bought in at the end of the calendar year, deductions for prepaid feed for the cattle have been central to the creation of tax losses in that year.⁶

Another deferral shelter involved the production and sale of eggs. In egg shelters, almost the entire amount invested and borrowed was spent on items for which deductions were claimed in the first year. These items included poultry flocks, prepaid feed, and (to some extent) management fees to the persons who operated the program for the investors. Under prior law, amounts paid for egg-laying hens, which are commonly kept for one year from the time they start producing, have been treated as allowable deductions in the year the poultry was purchased.⁷

Deferral and conversion shelters. —A deferral and conversion shelter has offered an investor an opportunity both to defer taxes and also to convert ordinary income into capital gain. The manner in which these benefits were obtained was by deducting development costs of section 1231 property (breeding cattle, orchards, vineyards, etc.) and capital gain property (farmland) from ordinary nonfarm income and by later selling the developed assets after the investor had held them long enough to qualify for long-term capital gain rates. Since the recapture rules which apply to deducted development expenses (e.g., section 1251) are much more limited in scope than depreciation recapture rules generally, many farm operations can be structured so that there will be little or no recapture of previously deducted development costs.

Livestock breeding has offered taxpayers the opportunity to defer taxes over a period of two or more years and also to convert ordinary income into capital gain. In general, breeding operations have relied on current deductions for prepaid expense items; current deductions for expenses of raising young animals to be used

for breeding, dairy, draft or sporting purposes; the investment credit; accelerated depreciation and additional first-year depreciation on purchased animals and equipment; and capital gain when the mature animals are eventually sold.

Although cattle has been the most widely used breeding shelter, there have also been investments offered for the purchase, breeding and sale of horses, fur-bearing animals (such as mink and chinchilla), other types of farm animals (such as hogs), and some kinds of fish and shellfish.

An investment in an orchard, vineyard or grove involves a “tree crop” as distinct from a “field” crop such as vegetables. The list of tree crop partnerships has covered virtually anything grown in an orchard or vineyard in the form of trees or vines which produce annual crops of fruits (e.g., grapes, apples or avocados) or nuts (e.g., pecans, pistachios or walnuts).⁸

During the development period of trees or vines, the owners have deducted costs of spraying, fertilizing, irrigating and cultivating the tree or vine to its crop-producing stage. They have also depreciated farm machinery, irrigation equipment, sprinkler systems, wells and fences which they installed on the property. They have also obtained the investment credit; and deductions were often available for interest, fees and some prepaid items. After the trees start producing fruit or nuts, the owner has depreciated the costs of the seedlings and their original planting. (These costs were capitalized when incurred.) Such depreciation has been used partly to shelter the annual crop income. Income from the crop sales is ordinary income. Capital gain is available, however, when the underlying land and the orchard are sold (except to the extent that recapture rules come into play).

Use of farming syndicates. —These special farm tax rules have been utilized not only by taxpayers who were actively engaged in farming enterprises with the intention of making a profit, but also by passive investors whose motivation, in large part, consisted of a desire to use these farming rules to shelter income from other sources. These passive investors were frequently members of “farming syndicates” formed by a promoter or operator. In order to offer attribution of losses and limited liability to the investor, a farming syndicate has generally been structured as either a limited partnership or as an agency relationship with a management contract (and with limited liability generally provided for by nonrecourse indebtedness, insurance, stoploss guarantees, etc.). During the 5 1/2 years between January 1, 1970, and July 1, 1975, the dollar amount of tax shelter offerings in partnership form registered with the National Association of Securities Dealers was \$942,424,000 in cattle feeding and breeding ventures and \$166,575,625 in vineyards and other farming shelters. (There have been many more private syndications which were not required to be registered.)

Congress believed that the special farm tax rules should be continued for most farmers who are actively engaged in farm operations, but that such special farm tax rules should be severely curtailed for farming syndicates in which a substantial portion of the interest is held by taxpayers who are motivated, in very large part, by a desire to shelter other income, rather than by a desire to make a profit in the particular farming operation.

Congress also believed that reducing tax incentives for high-bracket taxpayers who invest in syndicated farming operations will improve the competitive position of full-time farmers who must look to the income generated from farm operations for all or most of the return on their investment in farm operations.

Explanation of provisions

In general, the Act requires farming syndicates to deduct expenses for feed, seed, fertilizer, etc., only when used or consumed, to deduct expenses of purchased poultry only over their useful life (or, in the case of inventory, only when disposed of) and to capitalize certain cultivation, maintenance, etc., expenses of groves, orchards and vineyards to the extent such expenses are incurred before the grove, orchard or

vineyard becomes productive.⁹

Definition of farming syndicate. —For purposes of these provisions, a “farming syndicate” is defined as including (1) a partnership¹⁰ or other enterprise (other than a corporation which is not a subchapter S corporation) engaged in farming if, at any time, any interest in the partnership or other enterprise has been offered for sale in an offering required to be registered with a Federal or State agency having authority to regulate the offering of securities for sale, (2) a partnership or other enterprise (other than a corporation which is not a subchapter S corporation) engaged in the trade or business of farming if more than 35 percent of the losses during any period are allocable to limited partners or limited entrepreneurs.¹¹

These categories include as farming syndicates many forms of organization of farm enterprises such as general partnerships, sole proprietorships involving agency relationships created by management contracts, trusts, and interests in subchapter S corporations.¹² If an interest in any such enterprise has been offered for sale in an offering required to be registered, it is a farming syndicate. Similarly, unless excepted by the five specific exceptions described below, if more than 35 percent of the losses during any year are allocable to limited partners or limited entrepreneurs, the enterprise will be treated as a farming syndicate.

In general, a limited entrepreneur means a person who has an interest, other than a limited partnership interest, in an enterprise and who does not actively participate in the management of the enterprise. The determination of whether a person actively participates in the operation or management of a farm depends upon the facts and circumstances. Factors which tend to indicate active participation include participating in the decisions involving the operation or management of the farm, actually working on the farm, living on the farm, or hiring and discharging employees (as compared to only the farm manager). Factors which tend to indicate a lack of active participation include lack of control of the management and operation of the farm, having authority only to discharge the farm manager, having a farm manager who is an independent contractor rather than an employee, and having limited liability for farm losses.¹³

With respect to farming activities other than those conducted by enterprises in which securities have been registered or were required to be registered, the provision specifies five cases where an individual's activity with respect to a farm will result in his not being treated as a limited partner or limited entrepreneur. These cases cover situations where an individual —

- (1) has an interest in a trade or business of farming attributable to his active participation for a period of not less than 5 years in the management of the trade or business of farming¹⁴ ;
- (2) lives on the farm on which the trade or business of farming is being carried on (but only with respect to farming activities on such farm);
- (3) actively participates in the management of a trade or business of farming which involves the raising of livestock (or is treated as being engaged in active management pursuant to one of the first two exceptions set forth above), and the trade or business of the partnership or any other enterprise involves the further processing of the livestock raised in the trade or business with respect to which he is (actually or constructively) an active participant;
- (4) actively participates, as his principal business activity, in the management of a trade or business of farming, regardless of whether he actively participates in the management of the activity in question; or
- (5) is a member of the family (within the meaning of section 267(c)(4)) of a grandparent of an individual who would be excepted under any of the first four cases listed above and his interest is attributable to the active participation of such individual.

The first exception listed above (and its application to family members by the fifth exception) is designed to insure that the term “farming syndicate” does not include an enterprise in which a limited partnership interest (or other passive interest) is held by a person who has actively participated in the management of

the enterprise for not less than five years merely by reason of his holding such a limited partnership interest (or other passive interest). Also, a member of the family of such a person, such as one of his heirs, would not be treated as a limited partner or limited entrepreneur for purposes of making the farming enterprise a farming syndicate. Thus, for example, if A, an individual who has owned and operated a farm for more than five years, wishes to retire and forms the AB limited partnership with B, an unrelated individual, and more than 35 percent of the losses are allocated to A, the limited partner, the AB partnership will not be treated as a farming syndicate because A's interest is not treated as a limited partnership interest for purposes of determining whether losses are allocated to limited partners. Similarly, if A later dies and the partnership is continued by B and C, A's son, the BC partnership will not be treated as a farming syndicate.

Definition of farming. —For purposes of these farming syndicate rules, the term “farming” is defined to mean cultivation of land or the raising or harvesting of any agricultural or horticultural commodity, including the raising, shearing, feeding, caring for, training, and management of animals. Thus, for example, a syndicate engaged in the raising of livestock, fish, poultry, bees, dogs, flowers, or vegetables is engaged in farming and, thus, is a farming syndicate.

For purposes of the farming syndicate rules, activities involving the growing or raising of trees (other than fruit or nut trees) are not considering farming. Thus, this provision does not apply to forestry or the growing of timber.

Deduction of prepaid items. —The Act adds a new section (sec. 464(a)) to the Code to provide in general, that, in the case of farming syndicates, deductions for amounts paid for feed, seed, fertilizer, or other similar farm supplies are allowed only in the taxable year in which the feed, seed, fertilizer or other supplies are used or consumed. This provision prevents a farm syndicate from obtaining current deductions for prepaid feed, seed, fertilizer, etc., except in situations where the feed, seed, fertilizer, or other supplies are on hand at the close of the taxable year solely because the consumption of such items during the taxable year was prevented on account of fire, storm, flood, or other casualty, or on account of disease or drought.

Costs of poultry. —Under prior law, taxpayers engaged in farming have not been allowed to deduct the cost of purchased livestock; rather, they must inventory the livestock held for sale and deduct the cost only upon disposition, and they must capitalize the cost of purchased livestock used in the trade or business (such as cattle held for breeding purposes) and depreciate them over their useful lives. However, this has not been the case with respect to poultry. A ruling by the Internal Revenue Service (Rev. Rul. 60-191, 1960-1 C. B. 78) has allowed cash basis taxpayers to deduct when paid the costs of both poultry held for sale and poultry used in the trade or business. These deductions were allowable, in general, because the poultry purchased for resale has a relatively small cost, and the poultry purchased for use in the trade or business, such as laying hens, has a useful life of less than one year. Some syndicates, however, have taken advantage of these rules and, coupled with the prior rules relating to prepaid feed, have utilized the deductions for poultry to create tax shelters.

The Act adds a new Code provision (sec. 464(b)) which does not allow a farming syndicate to deduct when paid costs of acquiring poultry. Rather, it requires that the cost of poultry acquired for resale not be deducted until the poultry is sold or otherwise disposed of. Also, in the case of poultry acquired for use in the trade or business (such as laying hens) or acquired both for use in trade or business and for later resale, the costs must be capitalized and (taking into account salvage value) deducted ratably on a monthly basis over the lesser of twelve months or their useful life in the trade or business.¹⁵

Capitalization of development costs of groves, orchards, and vineyards. —The Act amends section 278 to provide that, in the case of a farming syndicate, any amount otherwise allowable as a deduction which is attributable to the planting, cultivation, maintenance, or development of a grove, orchard, or vineyard, and which is incurred prior to the taxable year in which the grove, orchard, or vineyard begins to produce crops in commercial quantities is required to be capitalized. Such expenditures can thereafter be recovered by depreciation of the grove, orchard, or vineyard. A limited exception to this capitalization rule is provided for amounts allowable as deductions (without regard to section 278) which are attributable to a grove, orchard, or vineyard, which is replanted after having been lost or damaged while in the hands of the

taxpayer by reason of freezing temperatures, disease, drought, pests, or casualty.

Where these new rules apply to a situation in which section 278(a) (relating to capitalization of certain expenses of citrus and almond groves) requires capitalization but for a different period (4 years instead of the preproductive period), the rules of capitalization of section 278(a) apply prior to the capitalization rules with respect to farming syndicates. Also, if an amount is incurred as a cost of fertilizer, or other prepaid supplies, which is generally subject to the rules of new section 464(a), such amount is nonetheless subject to the farming syndicate capitalization rules of section 278(b). Thus, in such a case, no deduction would be allowed upon consumption of the fertilizer, but rather such amount would have to be charged to capital account.

Effective dates

The provisions of the Act relating to prepaid feed and other farm supplies and poultry expenses apply generally to amounts paid or incurred in taxable years beginning after December 31, 1975. In the case of farming syndicates in existence on December 31, 1975 (but only if there is no change in membership in the farming syndicate throughout its taxable year beginning in 1976), these provisions apply to amounts paid or incurred in taxable years beginning after December 31, 1976.¹⁶ The provisions relating to orchards, groves and vineyards do not apply where the trees or vines were planted or purchased for planting prior to December 31, 1975, or where there was a binding contract to purchase the trees or vines in effect on December 31, 1975.

Revenue effect

This provision will increase budget receipts by \$86 million in fiscal year 1977, \$32 million in fiscal year 1978, and \$34 million in fiscal year 1981.

b. Limitation of Loss With Respect to Farms to the Amount for Which the Taxpayer Is at Risk (sec. 204 of the Act and sec. 465 of the Code)

Prior law

Generally, the amount of depreciation or other deductions which a taxpayer has been permitted to take in connection with a property has been limited to the amount of his basis in the property. Likewise, in the case of a partnership, the amount of loss a partner may deduct is limited to the amount of his adjusted basis in his interest in the partnership. However, basis in a property has included nonrecourse indebtedness (i.e. a loan on which there is no personal liability) attributable to that property. Where a partnership incurs a debt obligation, and none of the partners has personal liability on the loan, all of the partners have been treated for tax purposes as though they shared the liability in proportion to their profits interest in the partnership (i.e. each partner's share in the nonrecourse indebtedness is added to his basis in the partnership). (See regulations §1.752-1(e)).

Also, there has been generally no limitation on deductions which take into account a taxpayer's protection against ultimate loss by reason of a stop-loss order, guarantee, guaranteed repurchase agreement, insurance

or otherwise.

Reasons for change

Taxpayers have combined the special farm tax rules (discussed under the farm syndicate section above) with nonrecourse indebtedness, and stop-loss orders, etc., to deduct losses in a taxable year which are substantially in excess of the maximum amounts they could ultimately lose with respect to their investments in farming. Although some of these situations may be limited by the restrictions on deductions imposed on syndicates (as described above), some farming shelters may not involve syndicates. Also, the limitations on syndicates do not affect all types of farming operations. For instance, winter vegetables, rose bushes and other nursery plants are not restricted by the restrictions on farming syndicates, except to the extent that such syndicates utilize prepaid seed, fertilizer, and other farm supplies. (The utilization of such prepaid items is not necessary for the creation of substantial tax shelter in these types of operations.)

Explanation of provisions

To prevent a situation where a taxpayer may deduct a loss in excess of his economic investment in farming operations, the Act provides that the amount of any loss (otherwise allowable for the year) which may be deducted in connection with a trade or business of farming, cannot exceed the aggregate amount with respect to which the taxpayer is at risk in each such activity at the close of the taxable year. (For more detail as to the application and scope of the at risk rule, see section 2, above.)

In applying the at risk provision to farming operations,¹⁷ Congress intends that the existence of a governmental target price program (such as provided by the Agriculture and Consumer Protection Act of 1973) or other governmental price support program with respect to a product grown by a taxpayer does not, in the absence of agreements limiting the taxpayer's costs, reduce the amount which such taxpayer is at risk.

In the case of farming activities carried on by an individual, the "at risk" provision applies separately to each farming activity. Whether a taxpayer is engaged in one or more farming activities depends on all the facts and circumstances of the case. Generally, some of the significant facts and circumstances in making a determination are the degree of organizational and economic interrelationship of various activities in which the taxpayer is engaged, the business purpose which is (or might be) served by carrying on the various activities separately or together, and the similarity of the various activities. Thus, for instance, if a rancher engaged in cattle raising on his own ranch also purchases cattle which he has placed in a commercial feedlot, he will generally be treated as being in two separate farming activities. However, if such a rancher were, as a consistent business practice, to take cattle raised on his own ranch and place them in a commercial feedlot, he might well be treated as engaged in only one farming activity.

All farming activities engaged in by a partnership or subchapter S corporation will be treated as one activity for purposes of applying this provision.¹⁸

Effective date

In the case of farm operations, the at risk limitation applies to losses attributable to amounts paid or incurred in taxable years beginning after December 31, 1975.

Revenue estimate

It is estimated that this provision will result in an increase in budget receipts of less than \$5 million annually.

In addition a limited partner who assumes personal liability on a loan to the partnership (made by a bank or other lender) but who obtains the general partner's agreement to indemnify him against some or all of any loss arising under such personal liability, is at risk only with respect to the excess of the amount of the indebtedness over the maximum amount covered by the indemnity agreement.

Thus, even prior to the changes made by the Act, section 278 of prior law specifically required capitalization of all amounts attributable to the planting, cultivating, maintaining or developing of an almond or citrus grove during the first four years after the grove was planted.

The offspring of purchased animals cannot be depreciated, however, since the owner is considered to have no cost basis in such animals. (As indicated earlier, however, the cost of raising such offspring can be expensed.)

Accelerated depreciation under a 150-percent declining balance method is also available for new farm buildings and for the costs of purchased vineyards and orchards. The capitalized costs of vineyards and orchards planted by the taxpayer may be depreciated on a 200-percent declining balance method.

MISC-LEG-DOC, General Explanation of the Tax Reform Act of 1976 (H.R. 10612, 94th Congress, P.L. 94-455) PART 2 of 14 , GPO December 29, 1976

General Explanation of the Tax Reform Act of 1976 (H.R. 10612, 94th Congress, P.L. 94-455) PART 2 of 14 GPO December 29, 1976

c. Method of Accounting for Corporations Engaged in Farming (sec. 207(c) of the Act and new sec. 447 of the Code)

Prior law

Under prior law, a taxpayer engaged in farming activities was allowed to report the results of such activities for tax purposes on the cash method of accounting, regardless of whether the taxpayer was an individual, a corporation, a trust, or an estate. As indicated in the discussion of the farming syndicate rules, the availability of the cash method for farmers has contrasted with the tax rules which govern nonfarm taxpayers engaged in the business of selling products. Such nonfarm taxpayers must report their income using the accrual method of accounting and must accumulate their production costs in inventory until the product is sold.¹⁹ Under the accrual method of accounting as applied to farming, if crops are harvested and unsold at the end of the taxable year, the costs attributable to such crops cannot be deducted in the taxable year but must be treated as inventory. However, even under the accrual method, it has been a longstanding Treasury practice to permit a farmer to deduct expenses paid in the taxable year so long as the crops to which these expenses relate are unharvested at the end of the taxable year. (I.T. 1368, I-1 C.B. 72(1922).)

The Internal Revenue Service has recently ruled that, for taxable years beginning on or after June 28, 1976, an accrual method taxpayer engaged in farming is required to inventory growing crops (unless the taxpayer uses the crop method of accounting).²⁰

Furthermore, except with respect to citrus and almond groves, a taxpayer engaged in farming has generally been allowed to deduct currently costs of developing certain assets used in the trade or business of farming (such as cultivation expenses of orchards and groves) even if an accrual method of accounting was used; however, taxpayers in other businesses are generally required to capitalize the costs of constructing or developing assets used in the trade or business.²¹

Reasons for change

Under the cash method of accounting, all items which constitute gross income are reported in the taxable year in which actually or constructively received, and expenses are deducted in the taxable years in which they are actually paid. The primary advantage of the cash method is that it generally requires a minimum of recordkeeping; however, it frequently does not match income with related expenses. Consequently, the cash method can be used to create tax losses which defer current tax liabilities on both farm and nonfarm income. Corporations, as well as individuals, can benefit by the time value of such deferral of taxes.

The opportunity for farmers generally to use the cash method of accounting, without inventories and with current deduction of certain expenses which are properly capitalizable, was granted over 50 years ago by administrative rulings. These rulings were issued at a time when most agricultural operations were small operations carried on by individuals. The primary justification for the cash method of accounting for farm operations was its relative simplicity which, for example, eliminates the need to identify specific costs incurred in raising particular crops or animals.

In recent years, however, many corporations have entered farming. While some of these corporations involve relatively small business operations owned by a family or a few individuals, other corporations conduct large farm businesses which have ready access to the skilled accounting assistance often required to identify specific farm costs. In addition, sophisticated farm operations have often been carried on by farm syndicates or partnerships consisting of high-income investors and a corporation representing a promoter of a farm "tax shelter."

In view of this, Congress believed it was appropriate to require that certain corporations, and certain partnerships, engaged in farming to this requirement small or family corporations in order to continue the cash basis method of accounting essentially for all those but the larger corporations engaged in farming.²²

Explanation of provisions

In general. —The Act adds a new provision to the Code (sec. 447) which requires that corporations (other than nurseries, certain "family owned" corporations, subchapter S corporations, and certain corporations with annual gross receipts of less than \$1,000,000) and certain partnerships to use the accrual method of accounting for farm operations and also to capitalize their preproductive period expenses of growing or raising crops or animals.

For purposes of this provision, farming is intended to be defined in the same manner as it is defined in the farming syndicate rules.²³ Since under this provision, a corporation engaged in forestry or the growing of timber is not thereby engaged in the business of farming,²⁴ this provision does not affect the method of

accounting (or treatment of preproductive period expenses) of corporations engaged in forestry or the growing of timber.

Certain excepted corporations. —The Act provides a series of exceptions to the rule that farming corporations must use the accrual accounting method. One exception to the required accrual accounting rules is provided for nurseries. Thus, a corporation which is engaged in the business of operating a nursery will not be required to utilize the accrual method of accounting by reason of this provision of the Act. No inference is intended, however, with respect to any business operation which is required to utilize the accrual method of accounting under provisions of prior law.

Subchapter S corporations, which by definition can have no more than 15 shareholders, and certain family owned corporations are also excepted from the requirement of accrual accounting. A shareholder of a subchapter S corporation, however, is to be subject to the at risk provisions of the Act, and the corporation itself may also be farming syndicate.

A family corporation (excepted from the requirements of section 447) includes a corporation in which at least 50 percent of the total combined voting power of all classes of stock entitled to vote, and at least 50 percent of the total number of shares of all other classes of stock, are owned by members of the same family. For purposes of this provision, the members of a family are an individual, his brothers and sisters, the brothers and sisters of such individual's parents and grandparents, ancestors and lineal descendants of any of the above, a spouse of any of the above, and the estate of any of these individuals. Ownership of stock by a trust or partnership is to be proportionately attributed to its beneficiaries or partners, as the case may be.²⁵ Also, stock ownership is to be attributed proportionately through a corporate shareholder (in a farm corporation) to the owners of the corporate shareholder if 50 percent or more in value of the corporate shareholder is owned by members of the same family.²⁶ In applying these rules, individuals related by the half-blood or by legal adoption are treated as if they were related by the whole blood.

Since a principal justification for use of the cash method of accounting in agriculture is that small enterprises should not be required to keep books and records on the accrual method of accounting, a fourth exception to required accrual accounting covers small corporations. The provision exempts any corporation whose gross receipts (when combined with the gross receipts of related corporations) do not exceed \$1,000,000 per year. However, once this level of receipts is exceeded for a taxable year beginning after December 31, 1975, the corporation must change to the accrual method of accounting for subsequent taxable years and may not change back to the cash method of accounting for subsequent taxable years even if its receipts subsequently fall below \$1,000,000.²⁷

Application to partnerships. —Under this provision, a partnership is also required to use an accrual method (and to capitalize preproductive period expenses) if a corporation is a member of a partnership and the corporation itself would be required under this provision to use the accrual method for its farm operations. (Without a rule of this kind, a corporation directly engaged in farming could escape the general rule of this provision by becoming a partner in a partnership which could still elect the cash method of accounting for the benefit of its partners.) Where the rules of this provision apply to a partnership, noncorporate partners will be affected by the accounting method required to be used by the partnership.²⁸

Preproductive period expenses. —The term “preproductive period expenses” (required to be capitalized under this section) means, in general, any expenses which are attributable to crops, animals, trees, or to other property having a crop or yield, during the preproductive period of such property and which are allowable as deductions for the taxable year but for the application of this provision (and the farming syndicate rules, if applicable).²⁹

In the case of property having a useful life of more than one year, which will have more than one crop — such as an orchard or vineyard —the preproductive period extends until the disposition of the first marketable crop or yield. Thus, costs attributable to the cultivation, maintenance or development of an orchard or vineyard in a taxable year before the first year in which a marketable crop or yield is sold (and

which are currently deductible under prior law) are preproductive period expenses.³⁰

In the case of other farm property, such as annual crops (and animals with useful lives of less than one year), the preproductive period includes the entire period before the crop (or animal) is disposed of. For example, amounts paid for laying hens with a useful life of less than one year are “preproductive period expenses” if the hens are purchased in one year and sold in the following year. Similarly, in the case of winter vegetables which are planted in December of one year and harvested in January or February of the following year, a calendar year taxpayer would treat the cost of seeds, planting, cultivating, etc., of the vegetables in December as preproductive period expenses which must be capitalized and deducted only when the crop is sold.

The term “preproductive period expenses” does not include taxes and interest, and also does not include any amount incurred on account of fire, storm, flood, or other casualty, or on account of disease or drought.

With respect to preproductive expenses, there is a special disposition rule for home-grown supplies. This rule provides that, in the case of deductions which arise because feed is grown on a farm, and is fed to the farmer's chickens, cattle or other animals, the consumption of the feed by the animals transforms the deductions incurred in raising the feed into ordinary deductions in the year the feed is consumed. Such deductions are thus not required to be treated as preproductive period expenses, even though the animals may not be disposed of during that taxable year.

Annual accrual method of accounting. —The Act adds special rules which provide, in general, that, if a corporation (or its predecessors) has, for a 10-year period ending with its first taxable year beginning after December 31, 1975, used an “annual accrual method of accounting” and if the corporation raises crops which are harvested not less than 12 months after planting, the corporation may continue to use this method of accounting for its farming operations. An “annual accrual method of accounting” means a method of accounting under which revenues, costs, and expenses are computed on an accrual method of accounting and the preproductive period expenses incurred during the taxable year are either charged to crops harvested during that year or are currently deducted. To qualify to continue to use this method of accounting, substantially all of the crops grown by the corporation must be harvested not less than 12 months after planting. Also, the corporation (and its predecessors) must have used this method of accounting for at least 10 years. In order for a corporation to utilize the period another corporation has used the annual accrual method, the first corporation must have acquired the assets of a farming trade or business from the second corporation in a transaction in which no gain or loss was recognized to the transferor or transferee corporation.

In general, this 10-year requirement is designed to insure that the method can not be used by new or growing taxpayers to achieve substantial future deferrals, while permitting taxpayers who have had a substantial history of use of this method to continue its use.

If a corporation has used an annual accrual method of accounting together with a static value method of accounting for deferred costs of growing crops for a 10-year period prior to the first year to which these new provisions apply, it may elect to change to the annual accrual method of accounting without the static value method of accounting for deferred costs.

Period for taking adjustments into account. —A taxpayer who is required to change to the accrual method of accounting (or to revise his accrual method of accounting to capitalize preproductive period expenses) pursuant to this provision will be allowed to spread the accounting adjustments required by this method over a period of 10 years unless the Secretary of the Treasury by regulations prescribes different periods in certain types of cases. The corporation will also be treated as having made the change with the consent of the Secretary of the Treasury. Such a change will be treated as not having been initiated by the taxpayer (for purposes of the rule which prohibits adjustments resulting from changes in a taxpayer's method of accounting if the taxpayer initiates the change (sec. 481(a)).

The provision which states that the Secretary of the Treasury may prescribe regulations setting forth exceptions to the general rule that a corporation (or partnership) may spread the adjustments required by the change of accounting method over a 10-year period, is, in general, intended to give the Internal Revenue Service discretion to set forth standards as to when a different period for taking the adjustments into account would be appropriate.³¹

Effective Date

This provision will apply to taxable years beginning after December 31, 1976.

Revenue effect

It is estimated that this provision will result in an increase in budget receipts of \$8 million in fiscal 1977 and \$18 million annually thereafter.

d. Termination of Additions to Excess Deductions Accounts Under Sec. 1251 (sec. 206 of the Act and sec. 1251 of the Code)

Prior law

Under prior law (sec. 1251), individuals who reported their farm operations on the cash method of accounting, and who have more than \$50,000 of nonfarm adjusted gross income during a year, have been required to maintain an "excess deductions account" (EDA) for a net farm loss sustained in the same year to the extent the loss exceeds \$25,000. (It is immaterial what specific farm deductions produced the farm loss.) The EDA account is a cumulative account adjusted from year to year take into account net farm income or loss. For the most part, when the farm assets used in the taxpayer's business (except depreciable real property) are sold or otherwise disposed of, the portion of the gain on the sale or other disposition equal to the balance in the excess deductions account must be reported as ordinary income, rather than capital gain. Any gain recaptured in this manner is then subtracted from the balance in the EDA account as of the end of the same taxable year.³²

In the case of dispositions of farm land, another provision (sec. 1252) requires recapture of deductions allowed for soil and water conservation expenditures (sec. 175) and for land clearing expenditures (sec. 182) on a gradually reducing scale depending on how long the land is held. However, if recapture is required as a result of an EDA account, this recapture is to occur in the case of a gain or disposition even though the property is subject to a lesser recapture as a result of prior soil and water expenditures or prior land clearing expenditures.

Under prior law, if a corporation had a balance in an EDA account, an otherwise tax free reorganization in which farm recapture property was transferred to another corporation in exchange for its stock and the stock was then distributed would result in EDA recapture unless substantially all of the assets of the first corporation were transferred to the second corporation.

Reasons for change

Prior law allowed a farm investor who used the cash method of accounting to defer current taxes on his nonfarm income. It merely placed a potential limit on the amount of ordinary nonfarm income which might be converted to capital gain in a future year. Thus, even where an EDA account was required to be maintained, this provision reduced the conversion of ordinary income into capital gain but did not affect the time value of deferring taxes on nonfarm income or on annual farm crop income.

The experience with this provision since it was enacted in 1969 also suggested that the dollar floors which must be reached before farm losses were subject to recapture are quite high, and that the application of the provision was very limited. Treasury statistics of income since 1969 show that the number of tax returns which show nonfarm income of \$50,000 and higher and a net farm loss of \$25,000 or more has generally been less than one percent of all returns which report both nonfarm income and farm losses. Treasury statistics also show that the provision affects no more than 8 percent of the dollar amount of all farm losses reported on returns which show both nonfarm income and farm losses. Furthermore, it appears that the provision is difficult to apply and susceptible of varying interpretations.

Congress concluded that an approach which focused solely on preventing conversion of ordinary nonfarm income to capital gain, without limiting the initial deferral of current taxes on nonfarm income, did not deal effectively with the use of farm tax rules by high income taxpayers to “shelter” nonfarm income, particularly in some of the more flagrant abuses of the farm tax rules in publicly syndicated farm tax shelters which have been carefully structured to avoid or minimize the effects of section 1251.

Since the new provisions limiting the deductions in the case of farm syndicates, providing an at risk limitation for farm operations, and requiring certain corporations to use the accrual method of accounting, will prevent the deferral of taxes on nonfarm income in many cases, Congress did not believe that it was desirable to continue a complex rule of limited applicability in the statute which recaptures income previously offset by certain farm losses.

Also, Congress believed that it was inappropriate for EDA recapture to be triggered by a divisive “D” reorganization so long as the amounts in the EDA account would remain subject to recapture (under rules which are at least as stringent as if the reorganization had not occurred) when farm recapture property is disposed of by a corporation which survived the reorganization.

Explanation of provision

The Act limits the future applicability of the EDA provision (sec. 1251) by providing that no additions to an excess deductions account need be made for net farm losses sustained in any taxable year beginning after December 31, 1975. Farm losses incurred during any such taxable year or years will instead be governed by other limitations under the Act.

If property which is “farm recapture property” (within the meaning of section 1251(e)(1)) is disposed of during a taxable year beginning after December 31, 1975, however, the recapture rules of present law will continue to apply, but only with respect to EDA accounts required to be maintained for one or more years beginning before December 31, 1975.

The Act allows divisive “D” reorganizations without triggering EDA recapture. In these reorganizations, the entire EDA account is applied to both the transferor corporation and the transferee corporation.

Effective date

The amendments to section 1251 will not affect any recapture of farm losses by reason of a disposition of farm recapture property during a taxable year beginning on or before December 31, 1975.

In the case of dispositions of farm land, the termination of the provision described here for farm losses incurred in taxable years beginning after December 31, 1975, will mean that deductions taken under sections 175 and 182 in years beginning after December 31, 1975, will continue to be subject to recapture, but only to the extent required by section 1252. In such cases, section 1251 will cease to apply to any deductions under sections 175 and 182.

The provisions relating to “D” reorganizations apply to reorganizations occurring after December 31, 1975.

Revenue estimate

It is estimated that these provisions will result in a decrease in tax liability of less than \$5 million annually.

e. Scope of Waiver of Statute of Limitations in Case of Activities Not Engaged in for Profit (sec. 214 of the Act and sec. 183(e) of the Code)

Prior law

The tax law distinguishes between activities engaged in “for profit” and activities which are not engaged in for profit (sec. 183). In the case of an activity engaged in for profit, a taxpayer may deduct all expenses attributable to the activity even though they exceed the income from the activity. In the case of an activity not engaged in for profit, a taxpayer can deduct the allowable expenses attributable to the activity only to the extent that income derived from the activity exceeds amounts allowable for interest, taxes and casualty losses attributable to the activity. A taxpayer thus cannot utilize an operating loss incurred in an activity of this kind to offset his other income. Activities which raise issues of this kind include horse breeding, cattle breeding, the racing or showing of horses, and vacation homes.

In determining whether an activity is engaged in for profit, the facts and circumstances must be examined to determine whether the taxpayer entered the activity and continued it with the objective of making a profit. However, the tax law contains a provision under which an activity is presumed to be engaged in for profit if the activity shows a profit in at least 2 out of 5 consecutive taxable years ending with the taxable year in question. (In the case of raising, breeding, training or showing horses, the requirement is a profit in at least 2 of 7 consecutive years.)

If, at the end of a given year, the taxpayer has not conducted the activity for 5 (or 7) years, a special provision allows the taxpayer to elect to postpone a determination as to whether he can benefit by this presumption until he has conducted the activity for 5 (or 7) years (sec. 183(e)). This election was added to the Code in 1971. The committee reports at that time expressed an intent that a taxpayer who made the election should be required to waive the statute of limitations for the 5 (or 7) year period and for a reasonable time thereafter. The aim was to prevent statute of limitations (3 years, in the usual case) from running on any year in the period. The taxpayer, it was believed, should have time to claim a refund of tax

paid by him during the period, and the Internal Revenue Service should also have time to assess any deficiency owned by the taxpayer for any year in the period.

In carrying out this legislative intent, the Service has issued temporary regulations which require a taxpayer who makes an election under section 183(e) to agree to extend the statute of limitations for each taxable year in the 5 (or 7) year period to at least 18 months after the due date of his return for the last year in the period. Such an extension must apply to all potential income tax liabilities arising during the period, including issues unrelated to deductions subject to section 183 issues.

The reason for requiring such a broad waiver stems from a provision under prior law which, in certain circumstances, allows only one notice of deficiency to be sent to a taxpayer with respect to a taxable year. If a taxpayer receives a notice of deficiency and then files a petition with the Tax Court relating to that notice, the Service cannot (as a general rule) determine an additional deficiency for the same taxable year (sec. 6212(c)). Therefore, if, within the present limitations period, the Service sends a deficiency notice to a taxpayer relating to an issue other than section 183 and the taxpayer petitions the Tax Court as to one or more of those issues, the Service cannot later assess a separate deficiency under section 183. In order to prevent such a result, the temporary regulations require the waiver to cover all tax issues during the presumption period and not just the potential section 183 issues.

Reasons for change

The requirement that all items on a taxpayer's returns for the early years of a 5 (or 7) year period be kept open creates several problems. The taxpayer must retain all records for those years for a substantially longer period of time than otherwise would be the case. Leaving the statute of limitations open for the entire return because of an item which may well be relatively minor is also contrary to the policy of prompt resolution of tax disputes. A taxpayer may also want a prompt resolution of other items on his return in order to limit his potential interest cost as to any deficiency arising from items not related to the section 183 issues on his return.

In order to accomplish the purposes which Congress sought when it enacted the look-forward presumption of section 183(e), it is not necessary to keep the statute of limitations open for all issues on the taxpayer's return during the 5 (or 7) year period. The only issues on which the statute of limitations needs to remain open concern the deductions which will be tested as to whether they are incurred in an activity which the taxpayer engaged in for profit. Congress believes that a taxpayer should be able to take full advantage of a statutory presumption which was intended for his benefit, without unnecessarily extending the statute of limitations for items on his return which are unrelated to deductions which might be disallowed under section 183.

Explanation of provision

The Act revises prior law (sec. 183(e)) to provide that if a taxpayer elects to postpone the determination of his conduct of an activity under the presumption provisions, the statutory period for the assessment of any deficiency specifically attributable to that activity during any year in the 5 (or 7) year period shall not expire until at least two years after the due date of the taxpayer's income tax return for his last taxable year in the period.

If a taxpayer makes an election under section 183(e) and postpones a determination whether he engaged in a particular activity for profit, the making of this election automatically extends the statute of limitations, but only with regard to deductions which might be disallowed under section 183. The taxpayer would not

have to agree to extend the statute of limitations for any other item on his return during the 5 (or 7) year period. On the other hand, even if the taxpayer has petitioned the Tax Court with regard to an unrelated issue on his return for any year in the same period, the Service will be able to issue a second notice of deficiency relating to a section 183 issue as to any taxable year in the period.

In order to assure the Service adequate time to reexamine the section 183 issue after the suspension period has ended, this new provision allows the Service two years after the end of the period in which to contest the taxpayer's deductions. The making of the election extends the statute of limitations on any year in the suspension period to at least two years after the due date of his return for the last year in the period.³³ (The due date is to be determined without regard to extensions of time to file his return for the last year.)

The taxpayer's limited waiver of the statute of limitations would include not only the section 183 issue itself but also deductions, etc., which depend on adjusted gross income and which might be affected if the deductions are disallowed in accord with section 183.

The provision for this limited waiver is not intended to affect the scope or duration of any general waivers of the statute of limitations which taxpayers have signed (or sign) before the date of enactment of this Act (October 4, 1976).³⁴

Similarly, the bill does not affect general waivers of the statute of limitations which may be signed after enactment, since in order to avoid two controversies relating to overall income tax liability for the same year, a taxpayer may wish to postpone a resolution of non-section 183 issues until the information relating to the section 183 presumption is available.

Effective date

This provision generally applies to taxable years beginning after December 31, 1969. However, it will not permit a reopening of the statute of limitations for any taxable year ending before the date of enactment of the bill and as to which the statute of limitations has expired before such date of enactment. Further, since this provision does not limit general waivers of the statute of limitations, a taxpayer who has previously signed a general waiver will not be able to take advantage of this new provision (and to argue that the statute of limitations has run on issues unrelated to section 183) until his general waiver expires.

Revenue effect

This provision is not expected to have any revenue effect.

4. Oil and Gas

a. Limitation of Loss to Amount at Risk (see sec. 204 of the Act and sec. 465 of the Code)

Prior law

Under the tax law, an owner of an operating interest in an oil or gas well is allowed the option (under sec. 263(c)) to deduct as a current expense the intangible drilling and development costs connected with that well. Intangible drilling costs include amounts paid for labor, fuel, repairs, hauling and supplies which are used in drilling oil or gas wells, the costs of clearing of ground in preparation for drilling, and the intangible costs of constructing derricks, tanks, pipelines and other structures and equipment necessary for the drilling of the wells and the preparation of the wells for production. But for the statutory election to deduct these costs currently, they would, in the case of a successful well, be added to the taxpayer's basis and recovered through depletion and depreciation; in the case of a dry hole, the intangible costs would be deducted at the time the dry hole is completed.

In the case of an oil and gas drilling venture, which is most often a limited partnership, the Service has ruled (in Rev. Rul. 68-139, 1968-1 C.B. 311) that a limited partnership may earmark a limited partner's contribution to expenditures for intangible drilling costs, thereby allowing the allocation of the entire deduction to the limited partners (if the principal purpose of such allocation is not the avoidance of Federal taxes).

The Service has also ruled (Rev. Rul. 71-252, 1971-1 C.B. 146) that a deduction may be claimed for intangible drilling costs in the year paid, even though the drilling is performed during the following year, so long as such payments are required to be made in the first year under the drilling contract in question.

Generally, the amount of losses which a taxpayer is permitted to take in connection with a business or investment in an oil or gas property is limited to the amount of his basis in the property. In the case of a partnership investing in oil and gas properties, the amount of losses a partner may deduct is limited to the amount of his adjusted basis in his interest in the partnership. However, under prior law, basis in a property could include nonrecourse indebtedness (i.e., a loan on which there is no personal liability) attributable to that property. Where a partnership incurred a debt and none of the partners had personal liability on the loan, then all of the partners were treated for tax purposes as though they shared the liability in proportion to their profits interest in the partnership (i.e., each partner's share in the nonrecourse indebtedness was added to his basis in the partnership).

Reasons for change

The use of leverage through nonrecourse loans in an oil or gas drilling fund expanded the tax shelter potential of these investments to the extent that the leveraged amounts are used for intangible drilling and development costs. In these cases investors could deduct amounts to produce losses sufficiently in excess of their cash investment so that the tax savings in the year of investment could exceed the amount invested. For example, an investor contributing \$100,000 to a partnership for a 10 percent profits interest could have added to his basis another \$100,000 if the partnership obtained a nonrecourse loan for \$1,000,000. If all of the partnership's capital (\$2,000,000) were spent on drilling costs and the partnership had no income, the investor could deduct all of his share of those costs, or \$200,000. If the investor were in the 70 percent tax bracket, that deduction would reduce his taxes in that year by \$140,000, or \$40,000 more than his investment.

This leveraging of investments to produce tax savings in excess of amounts invested has substantially altered the economic substance of the investments and distorted the working of the investment markets. Taxpayers could be led into investments which were otherwise economically unsound and which constituted an unproductive use of the taxpayer's investment funds.

Explanation of provisions

To prevent a taxpayer from deducting a loss in excess of his economic investment in an oil or gas property, the Act provides that the amount of any loss incurred in connection with an oil or gas property may not exceed the aggregate amount with respect to which the taxpayer is at risk at the close of the taxable year. (The detailed provisions of the at risk rule have been discussed in section 2 above.) The limitation applies to all taxpayers (other than corporations which are not subchapter S corporations or personal holding companies) including individuals and sole proprietorships, estates, trusts, shareholders in subchapter S corporations, and partners in a partnership which condividuals and sole proprietorships, estates, trusts, shareholders in [Original text missing]¹

In general, in the case of an activity engaged in by an individual other than through a partnership, each oil and gas property (determined on a property-by-property basis, as defined for purposes of computing depletion under section 614) is treated as a separate activity. However, in the case of a partnership or subchapter S corporation, all oil and gas properties are to be treated as one activity.

For purposes of the 65 percent of net income limitation (under section 613A(d)), and the 50 percent of income from the property limitation (under section 613(a)), the deduction for intangible drilling and development costs is to be taken into account without regard to the at risk provision (i.e., on the assumption that the intangible drilling and development costs are fully deductible).

As discussed above, where the taxpayer has no personal liability with respect to a loan, he is to be considered at risk with respect to any indebtedness where the loan is secured by the taxpayer's personal or partnership assets (other than assets which are used in the same activity) which have an established value, to the extent of the value of the assets (net of any other nonrecourse indebtedness secured by these same assets). In the case of oil and gas wells, a property is not considered to have an established value unless sufficient drilling has taken place to establish proven reserves on the property.

Effective date

This provision is to apply to losses attributable to amounts paid or incurred with respect to oil and gas properties after December 31, 1975, in taxable years beginning after that date.

Revenue effect

This provision will increase budget receipts by \$50 million in fiscal year 1977, \$18 million in fiscal year 1978, and \$6 million in fiscal year 1981.

b. Gain From Disposition of an Interest in Oil and Gas Property (sec. 205 of the Act and sec. 1254 of the Code)

Prior law

Under the tax law, the operating interest in an oil or gas property is considered to be either a capital asset or

real property used in a trade or business. As a result, where the operating interest is sold after being held for more than six months,² the income from the sale will qualify for treatment as long-term capital gain. Similarly, an interest in a partnership is generally treated as a capital asset the sale of which will qualify for long-term capital gain treatment.

Prior law provided for the recapture of any deductions upon the sale of oil or gas property only to the extent that any deductions taken (under sec. 167) for the depreciation of tangible personal property (sec. 1245). Amounts deducted currently for intangible drilling and development costs (under sec. 263(c)) were not subject to recapture.

General reasons for change

The provision allowing gain from the sale of oil or gas property to be treated as capital gain without any significant recapture of deductions taken against ordinary income increases the value of an oil and gas tax shelter investment because it permits an investor, who has obtained a deferral of tax through the deduction of intangible drilling and development costs, to convert amounts which would in later years be taken into account as ordinary income into capital gains subject to the lower capital gains tax rates. The opportunity to convert these amounts into capital gains by selling the property occurs in all cases of producing wells where the option to deduct intangible drilling costs has been made. Even apart from tax shelter considerations, the Congress sees no reason why the principle which applies to other areas of the tax law (i.e., that deductions attributable to property should be subject to recapture if that property is sold or disposed of) should not also apply here.

Explanation of provisions

The Act provides for the recapture of certain intangible drilling and development costs upon the disposition of oil and gas properties if the disposition takes place after December 31, 1975. The amount subject to recapture is the amount deducted for intangible drilling and development costs (paid or incurred after December 31, 1975), reduced by the amounts which would have been deductible had those intangible costs been capitalized and deducted through cost depletion. However, the amount recaptured cannot exceed the amount of gain realized from the disposition. The amount recaptured is to be treated as gain which is ordinary income and is to be recognized upon the disposition of the property, regardless of any other provision of the Code which would otherwise provide for nonrecognition.

The recapture provision applies to all intangible drilling and development costs which, but for the option to deduct these costs under section 263(c), would be reflected in the adjusted basis of the property at the time the costs are paid or incurred. Amounts subject to recapture are to be reduced by the amount of cost depletion attributable to those intangible drilling and development costs actually deducted or permitted to be deducted under cost depletion (under sec. 611).

Costs which, but for the election to deduct intangibles, would be added to basis and recovered through depreciation (rather than to cost depletion) are to be recaptured under this provision.³

This net amount of intangible drilling and development costs over the amount allowable under cost depletion is to be treated as ordinary income only to the extent of any gain realized (or to the extent of the excess of the fair market value of the property transferred over the basis in the property). This limitation on the amount recaptured to the amount of gain (or the excess of fair market value over basis) is the same limitation applied (under sec. 1245) for the recapture of certain depreciation or amortization expenses relating to personal property. The computation of the amount realized, the fair market value of any interest,

and the adjusted basis of the property are to be made under substantially the same rules which apply to that provision.

The rules of this provision are to be applied separately to the intangible costs attributable to each oil and gas property. A property is defined for purposes of these rules in the same way as under the existing rules (under sec. 614) for purposes of computing the amount of depletion allowable. Thus, each different taxpayer's interest in a tract or parcel of land is generally to constitute a separate property, but all of a single taxpayer's operating interests in one tract or parcel of land are generally to be combined. However, if one or more taxpayers combine their interests for depletion purposes under a pooling or unitization agreement (as described in sec. 614(b)(3)), the property is to include all of the interests as so combined.

A property is to be considered an oil or gas property only if intangible drilling and development costs are properly chargeable to that property (either in the hands of the taxpayer or his predecessor in interest). Thus, an interest in a tract or parcel of land which is not an operating interest does not constitute an oil or gas property.

The recapture rule is to apply to all taxpayers who own oil or gas properties, including citizens and residents, trusts and estates, and corporations.

The recapture rule applies to the disposition of all or any portion of an oil or gas property. In the case of a disposition of a portion of an oil or gas property other than an undivided interest, the entire amount of intangible costs attributable to that property are to be allocated to the portion of the property which is first disposed of. Any excess of intangible costs not recaptured in the first disposition of a portion of an interest other than an undivided interest (because, for example, the gain realized from the disposition was less than the amount of costs subject to recapture) is to be subsequently allocated to the remaining portions of the oil or gas property. However, in cases of dispositions of a portion of an oil or gas property which are not subject to recapture under this provision (such as gifts), a proportionate part of the intangible costs subject to recapture is to be treated as allocable to the portion of the property transferred and is to be treated in the hands of the transferee as a transfer of a separate oil or gas property.

In the case of a disposition of an undivided interest in an oil or gas property or in a portion of an oil or gas property, a proportionate part of the intangible costs attributable to that property are to be allocated to the undivided interest and recaptured to the extent of the gain from the disposition of the undivided interest. For purposes of this rule (as well as for purposes of the rule relating to gifts and other nonrecapture dispositions as discussed in the next paragraph), it is intended that the expenditures are to be allocated in proportion to the rights to income from the property.

The recapture rule is to apply to all dispositions generally except those which are not treated as dispositions under the existing recapture provisions relating generally to gains from the disposition of depreciable personal property (sec. 1245). This provision excepts from recapture dispositions by gift, transfers at death, transfers in certain tax-free reorganizations, like-kind exchanges and involuntary conversions in certain circumstances, and certain sales or exchanges required by order of Federal agencies. These same exceptions are to be applied under regulations in the appropriate manner to the recapture of intangible drilling and development costs from oil or gas properties. Also, for purposes of this provision a unitization or pooling arrangement (within the meaning of section 614(b)(3)) is not to be treated as a disposition.⁴

In addition, the rules relating to the distribution of property by a partnership to a partner which are applied (under sec. 617(g)) to distributions of any property or mine with respect to which mining exploration expenditures have been deducted are to be applied in a similar manner to the distribution of oil or gas property to a partner and to the distribution of other property to a partner by a partnership which, after the distribution, continues to hold oil or gas property.

For purposes of these rules, where a partner sells or exchanges his interest in a partnership holding an interest in oil or gas property, intangible drilling costs which would be subject to recapture under these

provisions (should the partnership dispose of its interest in the property) are to be treated as an unrealized receivables (within the meaning of section 751). Thus, any gain realized by the partner upon the sale or exchange of his interest would be subject to ordinary income treatment to the extent of his share of these costs. Similar rules are to apply upon the sale or exchange of stock in a subchapter S corporation (in accordance with regulations to be prescribed by the Secretary or his delegate).

Effective date

The rules providing for the recapture of deductions for intangible drilling and development costs are to apply to dispositions of oil and gas properties in taxable years ending after December 31, 1975, with respect to intangible drilling and development costs paid or incurred after December 31, 1975.

Revenue effect

It is estimated that this provision will result in an increase in budget receipts of \$7 million for fiscal year 1977, \$14 million for 1978, and \$65 million for 1981.

5. Motion Picture Films

a. At Risk Rule and Capitalization of Production Costs (secs. 204 and 210 of the Act and secs. 280 and 465 of the Code)

Prior law

Under prior law, motion picture shelters generally had two basic forms. In one format, a limited partnership was formed to purchase the rights to an already completed film. The purchase price was heavily leveraged (and often unrealistically inflated) and the partners claimed substantial depreciation deductions. The principal features of the shelter was deferral and leverage. This format was sometimes referred to as a “negative pick-up” or “amortization purchase” transaction.

In the second type of format, the limited partnership was formed to produce a film (rather than to buy a completed film). The partnership entered into an agreement with a studio, with a distributor or with an independent producer to produce a particular film. The partnership used the cash method of accounting and wrote off the costs of production as they were paid. Typically the partnership was heavily leveraged and significant costs were paid with borrowed funds. The principal elements of this form of motion picture shelter were also deferral and leverage. The partnership in this type of shelter was sometimes referred to as a “service company” or “production company.”

Another variation of this shelter was the film distribution partnership. In this shelter, the partnership also did not own an interest in the film, but obligated itself to distribute the film. By writing off the costs of distribution, the deferral occurred for the partners because the partnership's income from its distribution services was not realized until later years.

The basic principles of partnership tax law which benefited the motion picture tax shelter (and other shelters as well) included the use of the partnership form to allow limited partners to take into income their distributive share of the partnership's income or losses (which are generally determined under the partnership agreement). Also, the amount of partnership loss which the partner may deduct included not only his own equity contributions to the partnership, but also his share of any nonrecourse debt which the partnership has incurred (see regulations §1.752-1(e)). There were also several aspects of prior law, however, which relate particularly to motion picture shelters.

(1) Film purchase shelter

The income forecast method. —Motion pictures were usually (and may continue to be under the Act) depreciated on the “income forecast” method. (Rev. Rul. 60-358, 1960-2 C.B. 68; Rev. Rul. 64-273, 1964-2 C.B. 62.) This method is used because, unlike most other depreciable assets, the useful life of a motion picture is difficult to ascertain. Under the income forecast method, the taxpayer computes depreciation by using a fraction, the numerator of which is the income received from the film during the year and the denominator of which is the total estimated income which the film is expected to generate over its remaining lifetime. This fraction is then multiplied by the cost of the film. For example, if the taxpayer has a basis of \$500,000 in his interest in the film, the income from the film through the end of the first year is \$750,000, and the total estimated income from the film over its lifetime is \$1,000,000, the taxpayer would be allowed to depreciate 75 percent of his basis, or \$375,000. (If the income forecast increases or decreases as a result of changed circumstances, this change is taken into account for later periods. Thus, in the second year, depreciation under the income forecast method might be based on an income forecast denominator which was more or less than the amount used for the first year.)

The film purchase transaction worked as a tax shelter only where the purchase price of the film (including nonrecourse indebtedness) exceeded its economic value.¹

However, there was a substantial question even under prior law whether taxpayers in a film-purchase shelter were legally entitled to claim depreciation based on nonrecourse indebtedness where the “purchase price” of the film was in excess of the income forecast on the film.

While the authorities in this area have not been uniform, there are several cases which have disallowed the depreciation deduction based on nonrecourse liability where there was no substantial prospect that this liability would be discharged. In *Leonard Marcus*, 30 T.C.M. 1263 (1971), the court held that where the taxpayer purchased two bowling alleys for a 5 percent down payment, with a 20-year nonrecourse note for the balance, the taxpayer could depreciate only the basis represented by his down payment, and that the note could be taken into account for purposes of increasing the taxpayer's basis only to the extent that payments were actually made. The court held that the liability represented by the note was too contingent to be included in basis until payments were made.²

You have reached the end of Part 01. To reach other parts, please use NEXT.