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Tax Equity and Fiscal Responsibility Act of 1982

Merlin G. Briner

TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982

by

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INTRODUCTION

ON AUGUST 20, 1982, President Reagan signed into law the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), the fourth piece of major tax legislation in less than seven years. Though TEFRA has been said to provide the single largest tax increase in American history, President Reagan lobbied for it not as a tax bill, but as a revenue measure which, to his mind, in no way represented a backing-off from his vaunted "supply side-trickle down" economic program.

In point of fact, the provisions of the Economic Recovery Tax Act of 1981 (ERTA), the cornerstone to the "supply side" program, remain largely intact. However over the next five years TEFRA will reclaim approximately $215 billion of the $750 billion given up by ERTA in the years 1981 to 1986. TEFRA eliminates the increased depreciation allowances scheduled for 1985 and 1986 under ERTA, but does not in any way affect the final 10% individual income tax rate reduction provided by ERTA, which will go into effect on July 1, 1983 as scheduled. Otherwise, TEFRA achieves its increased tax revenues by accelerating estimated tax payment schedules, imposing strict new compliance provisions, including new withholdings and heavier penalties, levying additional excise taxes, scaling back existing benefits and closing several significant loopholes.

TEFRA modifies the rules governing pension plans, life insurance companies, corporate mergers, acquisitions and redemption of stock, safe harbor leases, completed construction contract accounting, partnership audits and partners' liability for tax. Though it will affect a broad range of taxpayers, individual income taxes will only be increased in a limited number of situations. It seems, therefore, that the "trickle down" will be slowed to a drip, though from the individual's perspective this is infinitely preferable to having any more resources drained from an already depleted reservoir. Businesses, on the other hand, will be faced with increased planning challenges and uncertainties.

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1.00 PROVISIONS PRIMARILY AFFECTING INDIVIDUALS

1.01 Alternative Minimum Tax

I.R.C. §§ 55-58 - TEFRA § 201.

In order to advance economic and social purposes the Internal Revenue Code is often amended by provisions which, through deductions, credits, or otherwise, provide an inducement to taxpayers of all types to conduct activities consistent with the special purpose. The benefits garnered through such inducements are referred to as tax preference items. Some tax preference items are then subjected to a minimum tax to ensure that the tax burden is not unevenly distributed among the nation's taxpayers and that taxpayers do not receive an excessive benefit from the inducement offered.

In the case of individuals, two separate minimum taxes were previously imposed. The add-on minimum tax was 15% of the excess of the sum of six specific tax preference items over the greater of $10,000 or one-half of the regular income tax. The alternative minimum tax was a two-step graduated percentage (10-20%) of a taxpayer's alternative minimum taxable income (A.M.T.I.). The alternative minimum tax (A.M.T.), however, was only payable to the extent that it exceeded the sum of the regular and the add-on minimum taxes.

TEFRA repeals the add-on minimum tax but merges several of its attributes into an expanded A.M.T. A standard deduction of $30,000 ($40,000 on a joint return and $20,000 on the return of a married person filing separately) is now allowed against A.M.T.I. Amounts in excess of the standard deduction are now taxed at the fixed rate of 20%. Whereas under prior law A.M.T.I. was generally calculated by adding two tax preference items to taxable income, it is now calculated as follows:

(a) Determine Adjusted Gross Income (A.G.I.), with no deduction for net operating losses.

(b) Add the following tax preference items which were subject to either the add-on or the alternative minimum tax under prior law:
   (i) the 60% portion of long-term capital gain that is excluded from A.G.I.;
   (ii) accelerated depreciation on real property or on personal property subject to a lease in excess of straight-line depreciation over the useful life or recovery period of the property;
   (iii) amount of sixty-month amortization of certified pollution control facilities in excess of depreciation otherwise allowable;
   (iv) percentage depletion in excess of the adjusted basis of a property; and
   (v) intangible drilling costs on oil, gas and geothermal wells in excess of the amount amortizable with respect to the cost, and in excess of net income from related production.

(c) Add the following tax preference items made subject to the A.M.T. by TEFRA:
   (i) dividend and interest excluded from A.G.I. on the taxpayer's income tax return, including All-Savers interest and the 15% net interest exclusion effective after 1984, both of which are products of ERTA;
   (ii) the excess of mining exploration and development cost expense, research and development cost expense and magazine circulation and pre-publication expenditures over the amount of amortization of such items under the ten-year amortization election; and
   (iii) the excess of the fair market value of an incentive stock option on the date of its exercise over its exercise price.

(d) Subtract the income tax return amount of the following itemized

deductions:
(i) charitable contributions;
(ii) casualty losses;
(iii) home mortgage interest payments;
(iv) other interest payments to the extent of net investment income;
(v) estate taxes paid on items included in A.G.I.;
(vi) gambling losses; and
(vii) medical expenses to the extent that they exceed 10%.

(e) Subtract the alternative minimum tax net operating loss deduction. This deduction is equal to the regular net operating loss deduction reduced by the amount of loss year tax preference items taken into account in its computation and by the amount of the loss year itemized deductions taken into account in its computation which are not alternative minimum tax itemized deductions (see step (d), above).

The result is A.M.T.I. but as under prior law the A.M.T. is payable only to the extent that it exceeds the regular income tax. However, because A.M.T.I. is now based on A.G.I. and not taxable income, state and local taxes are no longer excluded from the minimum tax and, if the A.M.T. applies, a taxpayer will gain virtually no benefit from their prepayment.

The foreign tax credit, in an amount which is proportionate to the amount of A.M.T.I. which is from a foreign source, is the only tax credit which may be used to offset the A.M.T. The amount of any unexpired tax credit which may be carried to other tax years under the usual rules, however, is reduced only to the extent that the benefit of offsetting such credit against the regular income tax is not negated by the imposition of the A.M.T. For example, if a taxpayer reduces his or her regular tax to $5,000 by taking an investment tax credit of $5,000, but must pay an A.M.T. of $3,000 ($8,000 – $5,000 regular tax), the taxpayer receives no benefit for the $3,000 of the investment tax credit which may therefore be carried over to other years.

1.02 Medical Expense Deduction
I.R.C. § 213 - TEFRA § 202.

TEFRA raises the floor for deductible medical care expenses from 3% to 5% of A.G.I., and eliminates the prior law provision which allowed the deduction of one-half of any medical insurance premium paid, up to $150, without regard to any percentage floor.

Starting in 1983, medical insurance premiums will be grouped with all other medical care costs. The same will be done in 1984 with medicine and drugs and the separate 1% floor for such items will be eliminated. The deduction for drugs will be further limited in 1984 to only prescription drugs and insulin.

1.03 Casualty Loss Deduction
I.R.C. § 165 - TEFRA § 203.

Under prior law, nonbusiness casualty losses were deductible only to the extent that each loss exceeded $100. TEFRA retains the $100 floor but provides that casualty losses are deductible only to the extent that in the aggregate they exceed 10% of A.G.I.

1.04 Taxation of Unemployment Compensation
I.R.C. § 85 - TEFRA § 611.

In addition to extending federal funding for unemployment benefits through March 31, 1983, TEFRA lowers the income threshhold above which such benefits must be included in A.G.I. Where previously single individuals could make as much as $20,000 before including unemployment benefits in their A.G.I., now they must include them when the A.G.I. reaches $12,000. The change for couples filing a joint return is from $25,000 to $18,000. This new taxation of unemployment compensation is effective for benefits paid in 1982 and subsequent years. Thus, the taxable portion of such benefits will now equal the lesser of the full amount of such benefits or one-half of the amount by which A.G.I. (after certain adjustments) plus the full amount of the benefits exceeds the lowered threshholds.

1.05 Individual Retirement Account (IRA) Provisions
I.R.C. §§ 219, 408, 409 - TEFRA §§ 243, 335

Under prior law, individuals were allowed a limited deduction from gross income equal to the amount of their contribution of funds or property into an IRA, except in three specific situations. TEFRA has created a fourth exception by disallowing a deduction for amounts paid after 1983 into an IRA which was acquired by the taxpayer as an inheritance.

Because amounts, not in excess of a taxpayer's earnings, which are contributed to an IRA are deductible when paid, the taxpayer's basis in his or her IRA is zero and all amounts distributed therefrom, unless rolled over in total into another qualified plan within sixty days after receipt, are fully taxable when received. TEFRA creates two new exceptions to this rule: (1) only that amount which is not rolled over into another qualified plan within sixty days will now be taxable, even if it is less than the total distribution; and (2) after 1983, tax-free rollover treatment will not be available to any part of an IRA distribution which is received on account of the death of the IRA participant, unless received by the surviving spouse of such recipient.

1.06 Early Distributions From Deferred Annuities
I.R.C. § 72 - TEFRA § 265.

A deferred annuity contract which does not qualify as an IRA or some other type of tax-qualified retirement plan does not net the purchaser a deduction from gross income for any portion of his or her purchase price, which purchase price represents his investment (basis) in the contract. But TEFRA does retain the provision that accumulated earnings under such contracts are not subjected to taxation until distributed.

Prior law provided that distributions which were made before the annuity contract's starting date were to be treated as a return of investment until the investment was fully recovered, a non-taxable event. TEFRA has reversed this rule by providing that all amounts so distributed are to be treated as taxable income until all the income has been withdrawn.

As before, amounts distributed after the annuity starting date are treated partly as a return of investment and partly as ordinary income. The portion of each subsequent payment which will be treated as a return of investment is determined as of the annuity starting date by reference to the ratio which is derived when the total investment is divided by the total expected return. The remainder is treated as ordinary income.

This provision of TEFRA was intended to discourage taxpayers from using deferred annuity contracts as short-term investment vehicles and tax shelters by withdrawing all of their investment tax free and leaving their earned income to accumulate additional earnings tax free. As if an additional inducement was necessary, TEFRA has instituted a 5% penalty tax on any amount of an early distribution which is included in income under the above rule. In addition, loans, assignments and pledges of such contracts will now be considered as distribution subject to these rules.

Contracts entered into prior to August 14, 1982 are treated as split contracts. The new rules apply only to the premiums paid and income earned on such premiums after that date. The 5% penalty applies only to distributions made after 1982 and only to the extent that they are allocable to an investment made after August 14, 1982 and during the ten years prior to the distribution. For this purpose, a distribution is to be allocated to the most recent investment.

1.07 Flexible-Premium Life Insurance Contracts
I.R.C. § 101 - TEFRA § 266.

With some exceptions, section 101 provides that the beneficiary of a life insurance policy may exclude from his or her gross income that amount of the proceeds paid as a result of the death of the insured. Current law also provides that the amounts added to the cash surrender value of such policies as interest are not currently taxable to the insured, even though they may be borrowed by the insured under the terms of the contract. This latter provision acknowledges that life insurance contracts are not generally purchased as an investment vehicle.

Flexible-premium contracts, also known as "universal life" and "adjustable life" contracts, provide for the payment of one or more premiums that are not fixed in timing or amount by the insurance company. Under such contracts, the lion's share of these discretionary premiums is allocated to the cash surrender value of the policy, and it therefore produces no more than a roughly equivalent increase in the amount of the death benefit. Such policies often allow

Because of these and other features, such policies resemble an investment more closely than pure insurance. They allow the insured to defer the taxation of current income and still preserve to the named beneficiary the right to receive the death benefit tax free. This fact, pronounced inconsequential by the IRS in 1981, was under reconsideration by that body at the time TEFRA was signed into law.

Under TEFRA, such policies must meet one of the two tests set forth below in order to qualify as pure insurance. If one or the other is not met at all times over the duration of the contract, the right of the beneficiary to exclude the proceeds from gross income is denied.

First Alternative Test: The sum of the premiums paid under the policy must never exceed the single premium at issue (or the sum of the level premiums) necessary to fund the contracted death benefits. In addition, the contracted death benefit must never be less than the applicable percentage of the contract's cash surrender value. The applicable percentage is 140% until the insured attains the age of forty, and it decreases 1% for each year of attained age above forty, until it reaches 105% at age seventy-six.

Second Alternative Test: The cash value of the contract must be restricted by its terms to an amount which does not exceed the net single premium at issue required to fund the contracted death benefit. This provision is effective for contracts entered into before January 1, 1983. (It would seem to be an oversight that TEFRA does not specifically make this provision effective for contracts issued after 1983.) However, life insurance companies are allowed, until September 3, 1983, to bring any contract issued before January 1, 1983 into compliance with these new rules. Death benefits paid under any contract prior to September 3, 1983 may be excluded from the gross income of the recipient in any event.

2.00 PROVISIONS PRIMARILY AFFECTING BUSINESS

ACCELERATED COST RECOVERY PROPERTY PROVISIONS
2.01 Repeal of Increased Allowances
I.R.C. § 168 - TEFRA § 206.

The Accelerated Cost Recovery System (ACRS) adopted under ERTA in 1981 provided that ACRS property could be depreciated in the early years of its ownership at a rate which approximated the 150% declining-balance method, and that such property could be depreciated on the straight-line method in the later years of its ownership when the straight-line method would produce a larger depreciation deduction. The rate increases scheduled for capital additions in later years were repealed by TEFRA. Thus, 150% declining-balance rates must now be used to depreciate later additions, where ERTA would have allowed 175% and 200% declining-balance rates in 1985 and 1986 and later years, respectively.

2.02 Investment Tax Credit (ITC): Basis Reduction
I.R.C. §§ 46, 48 - TEFRA § 205.

For taxable years ending in 1982 and thereafter, the limit on the total allowable ITC is reduced from $25,000 of a taxpayer's tax liability plus 90% of the excess of his or her tax liability over $25,000, to $25,000 plus 85% of his or her excess tax liability over $25,000.

In addition, TEFRA requires taxpayers to reduce the basis of ACRS property which is eligible for ITC by 50% of the available credit and by 50% of any available energy or "qualified rehabilitation of historic structures" credit. The reduced basis must be used to compute ACRS depreciation, depreciation recapture, and the amount of gain or loss on disposition. It is not, however, to be used or in any way given effect in computing earnings and profits.

If a lessor of qualified property elects to pass through the ITC to the lessee under existing rules, the lessor need not make the basis adjustment. The lessee, however, must include in income ratably over the ACRS recovery period an amount equal to the basis adjustment otherwise required.

In lieu of the basis adjustment a taxpayer may elect to take an ITC which is two percentage points less than otherwise allowed; 4% instead of 6% for three year ACRS property and 8% instead of 10% for other eligible property. A lessee can make the same election and thereby avoid the inclusion in income of the basis reduction required for non-lessee taxpayers.

As stated, the basis reduction is subject to recapture as if it were depreciation previously allowed. However, should an ITC asset be disposed of before it has been held long enough to earn the full amount of the ITC previously taken, then the basis of the asset is increased by 50% of the ITC recaptured for the purpose of determining gain or loss and the amount of depreciation recapture.

These provisions are demonstrated in the following example:

CORPORATE TAXPAYER

YEAR ONE:		TEFRA	
TAX YEARS ENDING AFTER 1982	PRE-TEFRA	2% ELECTION	REDUCED BASIS
Regular Tax Liability	$ 26,000	$ 26,000	$ 26,000
Effect of Basis Reduction on Tax	—	—	424
Regular Tax Liability	$ 26,000	$ 26,000	$ 26,424
Asset Cost (10 yr. ACRS)	265,000	265,000	265,000
ITC Rate	10%	8%	10%

ITC Available	26,500	21,200	26,500
ITC Limit ($25,000 + 90/85%)	(25,900)	(21,200)	(26,210)
ITC Carryback	$ 600	$ —	$ 290
Asset Cost	$265,000	$265,00	$265,000
Basis Reduction (½ ITC Available)	—	—	(13,250)
Asset's Depreciable Basis	$265,000	$265,000	$251,750
Depreciation at ACRS rate (8%)	(21,200)	(21,200)	(20,140)
YEAR TWO:			
Asset's Adjusted Basis	$243,800	$243,800	$231,610
ITC Recapture	$ 21,200	$ 15,900	21,200
½ ITC Recapture (basis adj.)			(10,600)
Asset Adjusted Basis at Date of Sale	$243,800	$243,800	$242,210
Asset Sales Price	265,800	265,800	265,800
Gain on Sale of Asset	$ 22,000	$ 22,000	$ 23,590
Capital Gain ($265,800-265,000)	(800)	(800)	(800)
Ordinary Gain-Depreciation Recapture	$ 21,200	$ 21,200	$ 22,790
TAX SUMMARY:			
Tax on Sale (40% marginal rate)	$ 8,800	$ 8,800	$ 9,436
ITC Recapture	21,200	15,900	21,200
Year One Regular Tax	26,000	26,000	26,424
Year One ITC	(25,900)	(21,200)	(26,210)
ITC Carryback	(600)	—	(290)
Net Tax	$ 29,500	$ 29,500	$ 30,560

As can be seen from the above example, the basis adjustment must be made in full even if the taxpayer is not able to use the full credit in the year of acquisition because of the new limits on the amount of the ITC. The 2% reduction gives the taxpayer an opportunity to avoid this problem with respect to the ITC, if the taxpayer so desires. If the property qualifies for both the energy or "historic structures" credit and the regular ITC, the 2% election will avoid basis reduction only as to the ITC. The election is made on a property by property basis, and where a partnership is involved, at the partnership level.

Should a taxpayer decide against the 2% election, however, TEFRA insures that the depreciation deductions lost due to the basis adjustment are returned. One-half (50%) of any credit which resulted in a reduction of basis under this provision and which expired unused under the existing carryback/carryover rules is now *deductible* by the taxpayer in the year following its expiration or, in the case of a taxpayer's termination, on the taxpayer's final return.

To the extent that the foregoing example suggests that it will always be beneficial to make the 2% election, it is misleading. This decision should be made only upon a full consideration of the relevant factors, such as: the length of the ACRS recovery period, anticipated holding period of ITC property, the present value of tax benefits, the marginal tax rate and the effect of the $5,000 direct expensing rule.

The basis reduction rule applies, generally, to assets purchased or constructed and placed in service and to qualified progress expenditures made after December 31, 1982. Transition rules are provided for constructed property and integrated manufacturing facilities placed in service before January 1, 1986.

PROVISIONS AFFECTING CORPORATIONS
2.03 Reduction in Tax Preference
I.R.C. § 291 - TEFRA § 204.

Corporations, other than electing Subchapter S corporations, continue to be subject to the add-on minimum tax of 15% of the amount of their tax preference items in excess of the greater of $10,000 or the full amount of the regular income tax. The tax preferences of a Subchapter S corporation are passed through to the shareholders and subjected to the alternative minimum tax discussed herein at section 1.01. Corporations, however, have never been subject to an alternative minimum tax.

The objective of TEFRA is to raise revenue. The changes made by TEFRA in the alternative minimum tax will contribute to this objective. On the other hand, the changes discussed below, while they appear to represent a tax increase, in many cases will actually result in a tax decrease.

Rather than increase the add-on minimum tax rate, Congress decreased by 10% the benefit previously available to corporations through the existing tax preferences which are subject to such tax. The Senate Finance Committee Report billed this action as a "valid response" to the "increasing concern [that] the equity of the tax system" was tipped in favor of business. Evidently, the concern was none too compelling, because Congress then decreed that only 71.6% of the amount of the tax preference items, as reduced under TEFRA, would be subjected to the minimum tax. What they took away with one hand they immediately gave back, and more, with the other.

The following example demonstrates that the net tax liability of a corporation in the 46% marginal tax bracket is unaffected by this provision of TEFRA.

Prior Law Base	Prior Law Tax	Calculation of Income Tax	TEFRA Base	TEFRA Tax
$ 200,000	$ 72,250	Income	$ 200,000	$ 72,250
(100,000)	(46,000)	Preferences	(85,000)	(39,100)
$ 100,000	$ 26,250	Net	$ 115,000	$ 33,150
		Calculation of Minimum Tax		
$ 100,000		Preferences	$ 85,000	
$ ×1.0		Reduction Factor	$ ×.716	
100,000		Preference Base	60,860	
(26,250)		Income Taxes	(33,150)	
73,750		Taxable Base	27,710	
×.15		Tax Rate	×.15	
$ 11,057	11,057	Minimum Tax	$ 4,157	4,157
	$ 37,307	Total Tax		$ 37,307

The 71.6% reduction factor was selected to achieve exactly this result for a corporation in the highest marginal tax bracket. Thus, corporations in lower tax brackets, and therefore receiving less benefit per dollar of tax preference, could actually benefit by this change. Example:

Prior Law Base	Prior Law Tax	Calculation of Income Tax	TEFRA Base	TEFRA Tax
$ 100,000	$ 26,250	Income	$ 100,000	$ 26,250
(50,000)	(17,500)	Preferences	(42,500)	(15,250)
$ 50,000	$ 8,750	Net	$ 57,500	$ 11,000
		Calculation of Minimum Tax		
$ 50,000		Preferences	$ 42,500	
$ ×1.0		Reduction Factor	$ ×.716	
50,000		Preference Base	30,430	

(10,000)*		Income Taxes	(11,000)	
40,000		Taxable Base	19,430	
×.15		Tax Rate	×.15	
$ 6,000	6,000	Minimum Tax	$ 2,915	2,915
	$ 14,750	Total Tax-Prior Law		$ (14,750)
		TEFRA TAX SAVINGS		$ 835

The following tax preferences which are subject to the minimum tax are affected in the manner indicated:

(a) In the case of a financial institution, the bad-debt reserve deduction will be reduced by 15% of the amount by which the otherwise allowable deduction exceeds the actual experience.

(b) The percentage depletion deduction for iron ore and coal (including lignite) will be returned by 15% of the amount by which the otherwise allowable deduction exceeds the adjusted basis of the property. This change is effective for taxable years beginning after 1983.

(c) Gain on the sale of depreciable real property, section 1250 property, is taxed under existing law as ordinary income to the extent, generally, that the depreciation taken thereon exceeds that amount which would have been taken had the straight-line method been used. The remainder, if any, is treated as a capital gain. In the case of personal property, section 1245 property, gain on sale is taxed as ordinary income to the extent of all depreciation taken thereon, regardless of the method employed. As with section 1250 property, the remainder is treated as a capital gain. Thus, when the sale of real property results in a gain, a larger portion of such gain will be accorded the preferential capital gain treatment than it would have been accorded had it been realized on the sale of personal property.

Under TEFRA, the amount of this difference is reduced by 15%. For example: If section 1250 property purchased in 1975 for $500,000 is depreciated $300,000 ($75,000 "accelerated") and sold for $600,000 in 1983, under prior law the total $400,000 gain would have been treated as $75,000 ordinary and $325,000 capital. If the same property had been accorded section 1245 treatment, the gain would have been $300,000 ordinary and $100,000 capital. The difference of $225,000 ($325,000 - $100,000), the amount accorded preferential treatment under section 1250 that is not accorded such treatment under section 1245, is reduced by 15% to $191,250, resulting in a $33,750 increase in that portion of the gain treated as ordinary income and

*Minimum deduction.

an equal decrease in that treated as a capital gain. Under TEFRA the capital gain is $291,250 and the ordinary gain is $108,750.

Though all of the capital gain is granted preferential treatment under the income tax, only 18/46 (39%) of such gain is subjected to the minimum tax under prior law. The 71.6% reduction factor discussed earlier is applied to this inclusion factor, reducing it to 28% in order to counterbalance the lost income tax benefits. However, because TEFRA isolates only a portion of the total capital gain which was accorded preferential treatment under the income tax, a dichotomy is created that must be observed when calculating that amount of capital gain which is subject to the minimum tax.

Thirty-nine percent (39%) of that portion of a capital gain which arises whenever the sales price of a property, real or personal, exceeds its original purchase price must still be subjected to the minimum tax. The capital gain subject to minimum tax in the above example is calculated as follows:

CAPITAL GAIN		PERCENTAGE		TAXABLE
$ 191,250	($325,000-100,000-33,750)	28	=	$ 53,550
$ 100,000	($600,000-500,000)	39	=	$ 39,000
$ 291,250	Total			$ 92,550

(d) Only 85%, instead of 100%, of the basis in pollution control facilities purchased after 1982 which are eligible for rapid write-off, five-year straight-line amortization, will now be eligible for such treatment. The remaining 15% must now be depreciated under the longer ACRS lives, but will not be subject to the real estate capital gain rules just discussed. For add-on minimum tax purposes, only 71.6% of the excess of the rapid write-off over the ACRS amounts will be taxable.

(e) Rapid amortization of child-care facilities is not reduced as an item of tax preference under the income tax, but is eliminated as a preference item subject to the minimum tax.

The existing corporate tax preference items listed below were also reduced by 15%. However, because they were not subject to the add-on minimum tax prior to TEFRA, their reduction will actually generate some additional revenues and no 71.6% reduction calculations will be required. Enacting this section of TEFRA, therefore, was not a completely vain act.

(a) In the case of a financial institution, 15% of the otherwise allowable interest deduction incurred to purchase or carry tax-exempt obligations acquired after 1982 will be disallowed. The amount of total interest expense allocable to tax-exempt obligations will be the pro rata amount determined by comparing the average adjusted basis of the tax-exempt obligations to the average adjusted basis of all the assets. The length of the averaging period is subject to IRS regulation.

(b) Domestic International Sales Corporations (D.I.S.C.) are not subject to U.S. income tax. Rather, under prior law, 50% of their income is annually taxed to the D.I.S.C. shareholders as if constructively distributed, while the remainder is deferred and taxed to the shareholders only upon dissolution. Under TEFRA the annual constructive distribution is increased by 15% to 57.5%.

(c) In the case of an integrated oil company, one conducting extensive marketing as well as production activities, 15% of the amount otherwise allowable as a deduction for intangible drilling costs incurred after 1982 must now be capitalized and depreciated on the straight-line method over thirty-six months. No ITC will be allowed with respect to such capitalized costs.

(d) Mineral exploration and development costs are now deductible as incurred. Fifteen percent (15%) of any such costs incurred after 1982 must be capitalized and depreciated as five-year ACRS property. The capitalized portion will, however, be eligible for the ITC.

2.04 Construction Period Interest and Taxes
I.R.C. § 189 - TEFRA § 207.

Individuals and Subchapter S corporations are required to capitalize interest paid or accrued during the period of construction of improvements to real property on debt incurred to finance such construction, as well as on any real estate taxes paid or accrued on such property during such period. TEFRA extends this same requirement to all corporations with respect to interest and taxes paid or accrued in connection with construction begun after 1982. As with individuals, such capitalized costs may be amortized on the straight-line basis over the ten years beginning with the year in which they are accrued.

The Treasury is required to issue regulations allocating interest to expenditures for real property where debt is not incurred or specifically designated in connection with a particular project. Some authorities speculate that such regulations will require the capitalization of the total interest expense that could have been avoided had funds not been expended for construction as is required for financial accounting purposes.

Special transitional rules allow corporations to avoid the application of this section if construction of a hotel, motel, hospital or nursing home is begun prior to 1984 in accord with a written construction plan that was in existence on July 1, 1982 and approved by the government before construction begins.

2.05 Acceleration of Income Tax Payments
I.R.C. § 6655, 6152 - TEFRA § 234.

Corporations are now required to make equal quarterly payments of estimated tax totaling 90%, instead of 80%, of their actual annual income tax. If payments of less than this amount are made, a nondeductible penalty equal to interest at the then-current prime rate is imposed on the amount of the shortfall. However, if at least 80% of the actual income tax is paid as required, the amount of the shortfall is penalized at only 75% of the then-current bank prime rate. The 75% rule can be expected to induce some taxpayers to ignore this provision and treat the 10% (90-80) shortfall as a favorable rate, short-term loan, as was often done when the penalty was only 9% and the prime was hovering in the 15-20% range.

The penalty is computed on a quarterly basis — i.e., if 22.5% (.90 × .25) of the actual year-end tax liability is not paid by the due date of the first installment a penalty is imposed. Forty-five percent (45% = .90 × .50) must be paid by the due date of the second installment, etc. The penalty (interest) runs from the due date of the installment, but may in any event by avoided if by such date payments are made equal to the appropriate fractional amount of (a) last year's tax, (b) the amount of tax which would have been imposed on the prior year's income under the current year's rates, or (c) 90% (instead of 80%) of the tax which would have been imposed if the year-to-date-of-installment income were annualized on a linear basis.

Because income is assumed to have been earned ratably over the year for the purpose of calculating the 90% of actual tax limitation and each of the three penalty exceptions, a corporation in a seasonal industry which earns a large portion of its income in the early part of the tax year is often forced to overpay its actual tax just to avoid a penalty. TEFRA, therefore, provides a fourth exception for corporations which earned 70% or more of their income in each of the three prior years within a period of six or fewer consecutive months. Qualified corporations may annualize their year-to-date-of-installment income to reflect the established pattern.

For example, if 65% of income is, on the average, earned in the first six months, then the current year's six-month income figure is annualized by dividing it by 65%. Tax is computed on that amount and multiplied by 65%, and again by 90%, to determine the minimum amount of total tax that is due on the date of the second installment in order to avoid a penalty. That amount, less the first installment, is the amount of the second installment.

Finally, TEFRA eliminates the right of corporations to elect to pay the balance due as shown on their final return in two equal installments. Regardless of what amount of estimated taxes are paid, if any, the entire balance is due two and one-half months after the close of the taxable year unless a hardship extension is granted.

2.06 Acquisitions and Distributions
I.R.C. §§ 301 et. seq. - TEFRA §§ 222-228.

Partial Liquidations

Under prior law, the following tax consequences occurred when a corporation effectuated a plan of partial liquidation by distributing appreciated property in exchange for its stock: (1) the corporation recognized no gain on the distribution of such property; (2) the shareholder recognized capital gain or loss on its stock based on the fair market value of the property received; and (3) the shareholder's basis in such property was its fair market value.

The same tax consequences occurred in the case of a complete liquidation of a corporation, unless such corporation was 80% owned by another corporation. In that event, though the liquidated corporation still recognized no gain, the parent corporation recognized no gain on the disposal of its stock and was required to carry the appreciated property at a basis equal to that of the property in the hands of the liquidated subsidiary.

In both situations, at least to the extent that such property was involved, the liquidated corporation was required to recognize gain to the extent of depreciation or LIFO reserve recapture, income from the disposition of the stock of a wholly owned foreign subsidiary or D.I.S.C. and investment tax credit recapture. If a parent corporation only partially liquidated its 80% subsidiary, however, it could utilize the consolidated return rules to achieve the benefits of a complete liquidation without the corresponding detriments.

Consider, for example, the case of a subsidiary which holds the stock of a wholly owned foreign subsidiary or D.I.S.C., the value of which equals 10% of the total value of its assets, and operating assets making up the remaining 90% of its total assets. By retaining the stock in the foreign subsidiary or D.I.S.C., the subsidiary avoided recognizing any gain on its disposition. The distribution of its operating assets to the parent then qualified as a partial liquidation. Under the consolidated return rules, which could not have been utilized if a complete liquidation had taken place, the parent/shareholder was able to defer the recognition of any gain on the receipt of the appreciated operating assets and yet, under the partial liquidation rules, received a step-up in basis in such assets equal to their fair market value.

In addition, under the consolidated return rules the partially liquidated subsidiary was not required to recapture investment tax credit upon the transfer of its assets and was allowed to defer the recognition of gain due to the recapture of depreciation and/or LIFO reserves until additional deductions were recognized by the parent due to such items. Another significant benefit which was not available when a complete liquidation was elected was the survival of the tax attributes (e.g., carryovers) of the subsidiary corporation.

Thus, at the cost of a deferred capital gain a corporate parent was able to preserve its subsidiary's tax attributes, avoid the recapture of ITC, defer recapture gains, and secure a stepped-up basis in the appreciated property. Because Congress felt that such a transaction was not readily distinguishable from a dividend distribution, it eliminated these benefits by (1) modifying the rules which provided for nonrecognition of gain by a corporation distributing its assets in a partial liquidation so that they only apply when the shares of a noncorporate stockholder are redeemed; (2) providing that each distribution which is one in a series of distributions in complete liquidation be treated as a distribution in complete, as opposed to partial, liquidation; and (3) empowering the Secretary of the Treasury to promulgate regulations to ensure that the repeal of the partial liquidation rules will not be circumvented through the application of other provisions of law, particularly the regulations pertaining to consolidated returns.

Thus, under TEFRA, the transaction detailed in the above example will generally result in dividend treatment by the parent corporation. Because it is a corporation, the parent corporation will generally not get a stepped-up basis in the distributed property. The subsidiary still will not recognize a gain due to the appreciation of the distributed property (see below), but will recognize a gain to the extent of any recapture and will be required to recapture any unearned ITC.

Redemptions

Under prior law, if a corporation repurchased less than all of its stock in a transaction which did not meet the technical requirements of the partial liquidation rules, the rules governing a redemption of stock would apply. Under these rules, a shareholder was required to treat the property received in redemption of his or her stock as a dividend, unless the distribution was not essentially equivalent to a dividend, was substantially disproportionate with respect to that shareholder, or was in complete redemption of all of the stock of the corporation owned by that shareholder.

TEFRA provides a fourth exception under which a shareholder may qualify the redemption of his or her stock as a distribution in payment for the stock giving rise to a capital gain or loss based on the fair market value of the property. Such an exception occurs where there is a distribution meeting the technical requirements of a partial liquidation under prior law, and when it is made in redemption of "qualified stock." Stock held by a *noncorporate* shareholder who held at least 10% of the value of the stock of the corporation for the preceeding five years is so qualified. Thus, the prior law partial-liquidation rules and benefits are still available to a noncorporate shareholder or what may be termed a "qualified shareholder."

Prior law provided that gain would be recognized by a corporation which redeemed its stock with appreciated property unless it (1) made a distribution pursuant to the Bank Holding Company Act or an antitrust divestiture decree; (2) made a distribution in redemption of all the shares of a stockholder who had owned 10% or more of the value of the corporation's stock for the preceding year; or (3) distributed the stock or an obligation of a corporation of which it had owned at least 50% for each of the preceding ten years; which corporation was engaged in a trade or business and had not received property in a substantial amount from the distributing corporation in the preceding five years.

TEFRA completely eliminates the exceptions relating to bank holding companies and antitrust decrees. The second exception above is modified by TEFRA so that it is available only if "qualified stock" is redeemed, stock held by a *noncorporate* shareholder for five years instead of one. The third exception is eliminated and replaced by an exception which requires that *more than* 50% of the stock of a "controlled corporation" be distributed in exchange for "qualified stock."

Thus, as a general rule, for a corporation to avoid the recognition of gain on the distribution of appreciated property in redemption of stock the corporation must redeem its stock from a noncorporate shareholder. TEFRA, however, does provide a new exception; nonrecognition is allowed if a distribution is made to a corporate shareholder which subjects such distribution to dividend rather than to sale-or-exchange treatment, regardless of whether the stock is surrendered.

Certain Stock Purchases Treated As Asset Purchases

As stated, prior law provided that upon the complete liquidation of an 80% subsidiary the parent corporation was to carry the subsidiary's assets at the subsidiary's basis. There was an exception to this rule, however, if the corporation purchased an 80% controlling interest in another corporation within a twelve-month period and then liquidated that corporation pursuant to a plan of liquidation adopted within two years of acquisition and completed within three years of adoption.

If such plan called for the distribution of the subsidiary's property to the parent, if the parent was entitled to carry such property at a basis equal to the purchase price of the subsidiary's stock. During the five-year period preceding the completion of liquidation, the parent, if it filed a consolidated return, was also allowed to utilize the subsidiary's tax attributes, which did not terminate until final liquidation. TEFRA eliminated this benefit by repealing the two-year election provision and replacing it with a new election provision which does not require actual liquidation. But it must be exercised within seventy-five days of the acquisition date and it terminates the subsidiary's tax attributes as of such date.

If a parent corporation elects to treat its stock purchase as an asset purchase, its election must be made as to all of the assets of the acquired corporation and for any and all of the lower-tier affiliates of the target corporation. The acquisition date is the date on which the corporation first acquires at least 80% of the voting and total shares of the target. For this purpose an acquisition of the target's stock by any member of the purchaser corporation's affiliated group is considered to be an acquisition by the purchasing corporation.

The purchasing corporation is deemed to have made an election if at any time during the consistency period (the period beginning one year prior to the twelve-month acquisition period and ending one year and one day after the acquisition date) it or any of its affiliates acquires any of the assets of the target or any of its lower-tier affiliates, other than in the normal course of business. The Treasury is empowered to prescribe regulations detailing how a purchasing corporation may otherwise make this irrevocable election, what minimal asset acquisitions will not trigger the deemed election, and when an asset acquisition will not trigger the deemed election because made to circumvent the seventy-five day election limitation.

When the election is made, the target corporation is treated as having sold all of its assets to a "new" corporation in connection with a complete liquidation as of the acquisition date. Thus, the target corporation must file a final income tax return as the deemed seller for the short year ending on the acquisition date.

It must recognize recapture income on the sale of its assets, appreciation gain to the extent and in an amount proportionate to the percentage of the value of its stock which is not owned by the purchasing corporation (unless it is actually liquidated within one year of the acquisition date), and any pre-acquisition date earnings. The "new" corporation does not become an affiliate of the purchasing corporation until the day after the acquisition date and thus none of the foregoing amounts may be reflected on any consolidated return of the purchasing corporation's affiliated group.

Type "F" Reorganizations

Type "F" reorganizations are those which involve only a change in identity, form, or place of organization. In such a reorganization, the transferor corporation has not been required to close its taxable year. Thus, type "F" reorganizations have been the basis for an exception to the general rule that post-reorganization losses may not be carried back to pre-reorganization years.

To eliminate this exception, TEFRA provides that such a reorganization will be permitted to involve only "one corporation." However, it is obvious that to effect a change of place of organization between two different states, two corporations are required, and this is so noted in the Conference Committee Report. Thus, the Committee Report explains that TEFRA is intended only to preclude the involvement of more than one "operating company." This provision, therefore, overrules a number of court cases permitting such combinations to be effected for the purpose of making carrybacks available.

The Use of Holding Companies to Bail Out Earnings

Dividend treatment is generally accorded by a shareholder to the proceeds of a stock redemption which is not in partial or complete redemption of his or her corporation and which does not result in the termination or disproportionate reduction of the shareholder's interest. In order to avoid the rules which require such treatment, but still draw out the corporation's earnings, shareholders sometimes incur a debt collateralized by their stock and then transfer their stock to a newly-formed holding company in exchange for its stock and its assumption of the debt for the newly borrowed funds. In the alternative, the stock is simply transferred to a newly-formed holding company in exchange fòr both common and preferred stock. The preferred stock is then sold.

There have been conflicting court opinions as to whether the first device constitutes a tax-free incorporation or a redemption under the existing anti-bailout rules which apply where controlled corporations are involved. In the worst scenario, the redemption rules would have been applied and thus the distribution would not have qualified under such rules for capital gain treatment. The dividend rules would then have been applicable, and because the newly-formed corporation would have had no earnings and profits out of which dividends could have been paid the shareholder would have been entitled to capital-gain treatment. The shareholder would therefore have successfully bailed out the first corporation's earnings without increasing ordinary income.

Because in the second situation the preferred stock was issued by a newly-formed corporation, it was not tainted under the existing anti-bailout rules which required that the shareholder recognize ordinary gain on the later disposition of any tainted preferred stock. Thus, the shareholder would have again successfully bailed out the original corporation's earnings without incurring ordinary income.

To remedy these abuses, TEFRA provides that: (1) the anti-bailout rules and not the tax-free exchange rules apply to the extent that property other than stock is distributed by the newly-formed corporation; (2) the assumption of a shareholder's liability by a newly-formed corporation is to be considered a distribution of property other than stock; (3) the earnings and profits of the first corporation are to be considered the earnings and profits of the new corporation for the purpose of determining if earnings and profits are sufficient to support a dividend distribution in the form of an assumed liability; and (4) if the receipt of money in lieu of preferred stock would have been taxed as a dividend if the earnings and profits of the original corporation were attributed to the new corporation, then the shareholder must recognize dividend income to that extent upon the later resale of such preferred stock.

The assumption of a liability by the newly-formed corporation will not be treated as a distribution of property other than stock under these expanded anti-bailout rules only if the liability was incurred by the shareholder to purchase the transferred stock.

Waiver of Family Attribution

In determining whether a shareholder has completely terminated or disproportionately reduced his or her interest in a corporation so as to be allowed to treat the proceeds of the redemption of his or her stock as payment for such stock and not as a dividend, existing law allows the shareholder to waive the attribution of ownership rules with respect to the shareholder's family members if he or she agrees not to reacquire any interest in the corporation for a ten-year period.

Though the IRS takes the position that only an individual may waive such rules, several dividend cases have held that a waiver may be made of family attribution from a family member to the beneficiary of a trust or estate by the trust or estate which is terminating its interest in a corporation. In the case of *Rickey v. United States,* 592 F.2d 1251 (5th Cir. 1979), it was held that a trust or estate may waive attribution from its beneficiary to itself.

TEFRA provides, in line with the case law, that a trust or estate may indeed waive attribution between family members and its beneficiaries but only if those through whom ownership is attributed to the entity join in the waiver. Thus, after redemption neither the entity nor its beneficiary may reacquire an interest in the corporation for ten years. In the event that such an interest is reacquired, both will be jointly and severally liable for any tax deficiency. The rule in *Rickey v. United States* is therefore overruled by TEFRA.

Effective Dates

These changes are generally effective for transactions taking place after August 31, 1982.

LEASE PROVISIONS

2.07 Safe Harbor Leases

I.R.C. § 168(f) - TEFRA § 208.

Before the passage of ERTA, the determination of whether the lessor or the lessee got the tax benefits associated with the ownership of property (e.g., ITC and depreciation) was made on a case-by-case basis and was governed by court and IRS rulings. Essentially, these rulings held that the party who was entitled to the other traditional burdens and benefits of property ownership was also entitled to the tax benefits thereof. The uncertainty of such a determination was eliminated when ERTA introduced the concept of a safe-harbor lease.

Safe-harbor leases were heralded as a major tax break because they allowed a taxpayer to acquire the tax benefits associated with property ownership without accepting the other traditional burdens and benefits required under prior law. Thus, a taxpayer could purchase a piece of property and then lease out the property under a lease which essentially transferred these traditional ownership attributes, and yet retain the right to take the tax benefit of ownership. In the alternative, a taxpayer could purchase property and then enter into a sale and leaseback arrangement. Under ERTA the sale was sufficient to transfer the tax benefits of ownership; the leaseback arrangement returned the other traditional burdens and benefits to the original purchaser.

TEFRA repeals these rules effective for leases entered into after December 31, 1983, and with respect to leases entered into or property placed in service after July 1, 1982, modifies them as follows:

(1) A 50% limitation is put upon the amount of non-safe-harbor related income taxes which may be avoided by safe-harbor lease benefits, even though disallowed benefits, deductions and credits may be carried forward, not back, to any other tax year subject to the same limitation.
(2) The lessor is required to depreciate his or her three, five, and ten year ACRS leased property over five, eight, and fifteen years, respectively.
(3) All non-safe-harbor related tax credits must be applied first.
(4) ITC available on leased property must be spread evenly over five years even though the total basis reduction (see section 2.02, above) must be made in the first year.
(5) The rate paid on underpayment of taxes is the maximum rate a lessor is allowed to pay the lessee on lessor obligations.
(6) The maximum term of a qualified safe-harbor lease is reduced from 150% to 120% of the class life of the leased property.
(7) The amount of lessee's ITC property available for safe-harbor treatment is limited to 45%.
(8) Safe-harbor benefits are denied for leases between related parties, for leases of public utility property and of property for which rehabilitation tax credits are claimed, and for leases to tax-exempt entities and foreign persons not subject to U.S. tax.
(9) The at-risk rules will not prevent certain closely-held corporations from acting as safe-harbor lessors.
(10) Rules are put in place governing the calculation of the amount of percentage depletion available to a lessee of safe-harbor property.
(11) Special transition rules are provided for leases of commercial passenger planes, mass commuting vehicles, auto manufacturing property and turbines and boilers of cooperatives.

The status of "ITC strip leases" (those where only the right to ITC, and not depreciation, is transferred, or vice-versa) is left up in the air. Though such leases are specifically allowed if entered into before October 20, 1981, no provision specifically affects such leases if entered into after October 19, 1982. The Treasury has reserved the right to deal with such leases in future regulations.

2.08 Finance Leases
I.R.C. §§ 168(f)(8), 168(i) - TEFRA § 209.

TEFRA establishes a new category of leases for tax purposes called "finance leases." Finance leases are agreements which cover eligible property, are entered into after December 31, 1983, and are characterized by the parties as a lease. As with safe-harbor leasing, the lessor must be a corporation other than a Subchapter S corporation, a personal holding company, a partnership, or a trust beneficially owned completely by such a corporation.

The concept of a finance lease represents a less-than-complete retrenchment to the pre-ERTA position with respect to leases, as set down in guidelines issued by the IRS in 1975. These guidelines, as set forth below, are important in their own right. If complied with, the restrictions enacted in TEFRA with respect to safe-harbor leases and finance leases are inapplicable. They provide that: (1) the lessor must have a minimum 20% investment unconditionally at-risk; (2) the lessee must have no investment in the property; (3) the lessee must not lend any part of the purchase price to the lessor or guarantee any loan to the lessor; (4) any purchase options must be at fair market value; (5) the lessor must not be able to force the lessee to exercise the purchase option; (6) the lessor must receive a profit and a positive cash flow from the lease, independent of his or her tax benefits; and (7) the property which is the subject of the lease must not be incapable of use by any one other than the lessee.

Thus although a finance lease must have economic substance exclusive of tax benefits and must not be contrived simply to facilitate the transfer of tax benefits, the above guidelines are eased so that lease treatment is allowed even if a fixed price purchase option is involved which is equal to at least 10% of the leased property's original cost and the leased property is useful only to the lessee.

Only accelerated cost recovery property which is new section 38 property is eligible for finance-lease treatment. However, a ninety-day window is provided so that property is treated as new property eligible for finance lease treatment if it is leased within ninety days after it has been placed in service by its owner.

Finally, the following safe-harbor rules put in place by TEFRA will also apply to finance leases:

(1) Public utility property and property for which rehabilitation tax credits are claimed are not eligible.

(2) Leases between related parties or with tax-exempt entities and/or foreign persons not subject to U.S. tax are not eligible.
(3) Only 40% (instead of 45%) of a lessee's otherwise eligible property may receive finance lease treatment until after 1985.
(4) A lessor may only avoid 50% of his or her non-finance lease-related tax liability and may carryover, but not back, any disallowed benefits (limitation removed after September 30, 1985).
(5) The percentage depletion calculation rules apply.
(6) The lessor must spread any finance lease-generated ITC over five years for property leased prior to September 30, 1985.

2.09 Motor Vehicle Operating Leases
I.R.C. § None - TEFRA § 210.

TEFRA prevents the IRS from retroactively denying lease treatment under the rules in effect prior to safe-harbor leasing for motor vehicle operating leases with business lessees. The reason is that such a lease permits or requires the rental price to be adjusted at the end of the lease term by reference to the amount realized by the lessor upon sale of the leased property. The provision applies retroactively to open taxable years and does not preclude the IRS from issuing such disqualifying regulations on a prospective basis. It does not apply to leveraged leases financed with non-recourse debt.

TAX-EXEMPT OBLIGATION PROVISIONS
2.10 Industrial Development Bonds (IDB)
I.R.C. §§ 103, 168(f) - TEFRA §§ 214-219, 221.

Small bond issues, to be tax-exempt as such under present law, are required to have a face value of less than $1,000,000. However at the option of the issuer, and subject to certain restrictions, the face value is allowed to be as large as $10,000,000. Under TEFRA, the $1,000,000 "small issue" tax exemption will no longer be available for any IDB issued as part of a single issue with other obligations having tax-exempt interest under any other provision of law.

In addition, each separate lot of IDB's will be treated as a separate issue for purposes of the face value test. The exception occurs when the proceeds of the entire issue are to be used with respect to facilities located in more than one state or when the entire issue has the same or a related person as the principal user.

Otherwise, TEFRA (1) denies the "small issue" exemption if the proceeds of obligations issued after December 31, 1982 are to be used to finance certain private, generally recreational, facilities; (2) conditions the grant of tax-exempt status for post-1982 issues upon compliance with certain reporting requirements which relate principally to the further condition that a public hearing be held and that public approval be obtained before issuance; (3) limits the average maturity of each issue to 120% of the average economic life of the facilities financed thereby; (4) requires, generally, that all property financed by post-June 1982 IDB's, and placed in service after 1982, be depreciated over ACRS useful lives on a straight-line basis; and (5) eliminates the "small issue" exemption completely for obligations issued after 1986.

2.11 Mortgage Subsidy Bonds
I.R.C. § 103A - TEFRA § 220.

The Mortgage Subsidy Bond Tax Act of 1980 created a tax exemption for interest on bonds, the proceeds of which were invested in residential real estate mortgages.

The bond proceed investment restrictions of the 1980 Act are relaxed by TEFRA for bonds issued after its enactment, as follows:

(1) The prior requirement that non-mortgage investments made with reserved bond proceeds be divested when the reserve requirement decreases is eliminated to the extent that such a divestiture would result in a loss in excess of the earnings on such non-mortgage investments which have not yet been paid or credited to the mortgages as required by prior law.
(2) The maximum purchase-price limitation on homes which may be financed by bond proceeds is increased from 90% to 110% of the area average purchase price and from 110% to 120% in targeted areas.
(3) The prior arbitrage limitation is relaxed by increasing from 1% to 1-$^{1}/_{8}$% the amount by which the effective interest rate on mortgages purchased with bond proceeds may exceed the yield on the bond.
(4) Effective also for the uncommitted proceeds of bonds issued after April 24, 1979, up to 10% of the lendable proceeds (total less costs and reserves) may be invested in mortgages issued by other than first-time buyers. Prior law made no such allowance except for certain unchanged exceptions.

EMPLOYMENT PROVISIONS
2.12 The Independent Contractor v. Employee Classification
I.R.C. §§ 3508, 3509 - TEFRA §§ 269, 270.

Classification As Such

As with the recipient of tip income (see section 3.06), an independent contractor is often in a position to under-report, or even completely fail to report, self-employment income. The status of independent contractor is, however, also desirable for legitimate reasons. One who engages an independent contractor is able to avoid the bookkeeping and IRS reporting (except of payments exceeding $600 in a year) that are involved when the same services are performed by an employee. In addition, the independent contractor has a longer opportunity to control and invest his or her money, since this individual can schedule within the law but more judiciously the amount and timing of income and employment tax payments.

The potential for under-reporting has caused the Treasury to fight tenaciously to have individuals classified as employees rather than as independent contractors. These disputes have been governed by a twenty-factor common law test which the courts have applied on a case-by-case basis. Though Congress has prohibited the Treasury from issuing regulations or rulings changing these common law rules before June 30, 1982, it has consistently since 1979 refused to adopt the five-factor safe harbor test first proposed by Congressman Gephardt of Missouri. In the TEFRA joint conference, the Congress again rejected the Gephardt safe harbor and again continued the prohibition against further Treasury regulations, this time indefinitely.

TEFRA did, however, resolve the issue with respect to two service groups. Qualified real estate agents and direct sellers will now be classified as independent contractors if substantially all the compensation they receive in cash or property is based on sales or output rather than hours worked, and if the services they perform are performed pursuant to a written contract which specifically provides that the person will not be treated as an employee for federal tax purposes. A qualified real estate agent is an agent licensed as such, and a direct seller is a person who sells consumer products to any party who intends to resell such products otherwise than from a permanent retail establishment.

Employer's Liability Upon IRS Reclassification

Under prior law, the IRS imposed upon employers who erroneously misclassified an employee as an independent contractor full liability for the amount of income and payroll taxes which would have been withheld if the employee had been properly classified in the first place. (Federal income-tax-withholding assessments were adjusted if the reclassified worker had paid the proper amount of income tax.)

Under TEFRA, an employer will generally only be liable for 1.5% of the wages of an employee who is misclassified for federal income tax purposes and 20% of the employee's share of Social Security tax if the employee is misclassified for FICA purposes. If the legally required information returns pertaining to the employer's erroneous classification are not filed, unless such failure is due to a reasonable cause these percentages will be doubled to 3% and 20%, respectively.

If, however, an employer's misclassification and resulting failure to withhold and remit taxes is due to an intentional disregard of the law, pre-TEFRA law, and not this section, will apply. The same result occurs if the employer withholds federal income taxes but not FICA taxes. In all events, the employer will remain liable for his or her full share of Social Security and unemployment taxes.

This provision was effective upon TEFRA's enactment but only with respect to assessments made after 1982.

2.13 Federal Unemployment Taxes
I.R.C. §§ 3301, 3302, 3306, 6157 - TEFRA § 271.

Effective January 1, 1983, the wage base upon which the employer's tax is calculated is increased from $6,000 to $7,000 and the tax rate is increased from 3.4% to 3.5% of such wages. The credit for payments to approved state programs remains at the 2.7% maximum, and the net tax is therefore increased to a minimum of 0.8%. Effective January 1, 1985, the tax rate is increased to 6.2% and the credit to a maximum of 5.4%. The net rate will still, therefore, remain at 0.8%.

2.14 Targeted Jobs Tax Credit
I.R.C. § 51 - TEFRA § 233.

The credit is extended for two years until December 31, 1984, and is expanded to include economically disadvantaged summer youth employees and cooperative education students hired after May 1, 1983 and August 31, 1982, respectively. The maximum credit available is 85% and 30% of the first $3,000 of wages paid, respectively.

Each employer of a sixteen- or seventeen-year-old youth may qualify once during the extended period with respect to any youth employed during any ninety-day period between May 1 and September 15. The definition of the term "economically disadvantaged" is unchanged. Employers qualifying for a second time with respect to a cooperative student may receive a credit limited to 15% of the first $3,000 or wages paid.

OTHER PROVISIONS AFFECTING BUSINESS
2.15 Accounting for Long-Term Construction Contracts
I.R.C. § None - TEFRA § 229.

Under existing law, a taxpayer may recognize taxable income from construction contracts ratably over the life of the contract, the "percentage of completion method," or defer the recognition of income completely until the contract's completion under the completed contract method of tax accounting. Section 229 of TEFRA directs the Secretary of the Treasury to promulgate regulations relating to the latter method of accounting to clarify the time at which a contract is to be considered completed, when multiple contracts are to be joined or severed for the purpose of determining the date of completion and thus the date of income recognition, and what costs directly benefit extended period contracts and must therefore be deferred until the related income is recognized.

The first two provisions are intended to eliminate the possibility, currently available to contractors, to defer income unreasonably by inserting contract provisions which unjustifiably defer completion or tie together several contracts as a single contract for reasons only incidental to the purpose of such contracts. The cost allocation provision is intended to redress the situation where income is deferred but costs related to its production are deducted as period costs.

The cost allocation rules apply to costs incurred in taxable years beginning after 1982 but only in connection with contracts entered into after that date. The extended period contracts to which the application of such regulations will be limited are those which the taxpayer estimates at the time of contracting will not be completed prior to the end of two years after the first date on which allocable costs are incurred. In the case of extended period, real property related "construction" contracts, however, the cost allocation provisions will not apply unless a three-year period to completion is estimated or the taxpayer had average annual gross receipts of $25,000,000 or more for the prior three years.

Under a phase-in provision, a percentage of the additional costs allocable to such contracts will remain currently deductible. For taxable years beginning in 1983, 1984, 1985 and years thereafter, the currently deductible percentage of additional allocable costs will be two-thirds, one-third and zero, respectively.

The Conference Committee Report indicates that the following will no longer be deductible as period costs:

(1) bidding expenses on contracts awarded to the taxpayer;
(2) distribution expenses, such as shipping costs;
(3) general and administrative expenses properly allocable to long-term contracts under regulations to be prescribed by the Secretary;
(4) research and development expenses that either are directly attributable to particular long-term contracts existing when the expenses are incurred or are incurred under an agreement to perform research and development;
(5) depreciation, capital cost recovery, and amortization for equipment and facilities currently being used, to the extent that they exceed depreciation reported by the taxpayer for financial accounting purposes;
(6) pension and profit-sharing contributions representing current service costs and other employee benefits;
(7) rework labor, scrap, and spoilage; and
(8) percentage depletion in excess of cost depletion.

Commerce Clearing House reports, in its *Law and Explanation,* at page 57, that the following costs will continue to be deductible as period costs:

(1) interest;
(2) marketing, selling, and advertising expenses;
(3) bidding expenses for contracts not awarded to the taxpayer;
(4) research and development expenses neither directly attributable to particular long-term contracts existing when the expenses were incurred nor incurred under an agreement to perform such research and development;

(5) losses under section 165 and the regulations thereunder;
(6) depreciation, capital cost recovery, and amortization for idle equipment and facilities;
(7) income taxes attributable to income received from long-term contracts;
(8) pension and profit-sharing contributions representing past service costs;
(9) costs attributable to strikes; and
(10) general and administrative expenses not allocable to long-term contracts under regulations to be prescribed by the IRS.

The amended regulations governing how a contract completion date will be determined will apply to taxable years ending after 1982. If such regulations, when promulgated, require that a taxpayer treat an existing contract as completed before the first taxable year ending after 1982, TEFRA provides that such contract shall be treated as completed on the first day of such taxable year. For taxpayers who use the annualization rules to compute their estimated taxes, TEFRA provides relief from any understatement of tax penalties which would otherwise result from the application of the completion date regulations.

Under the transition rules for the regulations pertaining to the severance of contracts, the income from any contract severed and then treated as completed prior to the first taxable year after 1982 is to be recognized at the same time at which any other contract from the same group is actually completed under the new regulations.

3.00 TAXPAYER COMPLIANCE PROVISIONS

WITHHOLDING PROVISIONS

3.01 Interest and Dividends

I.R.C. §§ 31, 275, 643, 3451-3456, 3502, 6042, 6044, 6049, 6682, 7205 - TEFRA §§ 301-308.

After July 1, 1983, payors of patronage dividends will be required to withhold and remit to the IRS income taxes equal to 10% of each such payment. The rule applies also to original issue discounts to the extent that such discounts must be taken into income in any tax year. The rule does not apply to interest paid on tax-exempt obligations by state and local governments or on any obligation issued by an individual.

Payees may avoid these withholding rules if they present their payor with an exemption certificate on a form to be prescribed by the IRS and qualify under one of the following categories:

(1) a corporation, tax-exempt organization, governmental body, trust, middleman, or nominee;
(2) an individual less than age sixty-five with a prior year tax liability of

$6,000 or less;

(3) an individual age sixty-five or older with a prior year tax liability of $1,500 or less;

(4) a married couple filing a joint return if one or the other spouse is age sixty-five or older and they had a prior year tax liability of $2,500 or less; or

(5) a married couple filing a joint return with a prior year tax liability of $1,000 or less.

Financial institutions may elect to defer the withholding required on interest earnings until the last day of any calendar year if the depositor agrees to maintain an account balance at least equal to the amount of withholding thereby deferred. Also, payors of interest may elect not to withhold tax from any annual aggregation or year-to-date payment which, when annualized, does not exceed $150.

If a payor cannot reasonably estimate what portion of a payment, if any, does not represent a dividend, the payor must withhold based on the full amount of the payment. Dividends do not include amounts or property paid in redemption of stock to which a shareholder may be required to accord dividend treatment or the undistributed taxable income of a Subchapter S corporation.

Understandably, financial institutions have been vocally displeased with the above rules. As a result of the building pressure, more than twenty repeal bills have been introduced in the House of Representatives. However, because the Reagan Administration estimates that their repeal would result in a $25 billion increase in the federal deficit through fiscal year 1983 the Administration and many Congressional leaders are strongly opposed to its repeal.

3.02 Payments of Deferred Income
I.R.C. § 3405 - TEFRA § 334.

The TEFRA changes in payments of deferred income apply to periodic distributions made from any employer deferred compensation plan and to any IRA or any commercial annuity after 1982, which is not otherwise subject to withholding. The payor of such distribution must, if the payee has not elected *for any reason* to avoid the operation of this section, withhold and remit income tax as if the distribution were a wage and, if the person has not filed a withholding exemption certificate, as if the person were a married individual claiming three exemptions. The required withholding on non-periodic distributions is 10% of the distribution unless it is a distribution of the participant's balance under a plan, in which case withholding is not required unless requested by the recipient.

Elections are binding until revoked and all the usual information reporting rules and penalties apply. Under existing law, withholding on distributions from such plans is only required if requested by the participant.

3.03 Incorrect Identifying Number
I.R.C. § 3402 — TEFRA § 317.

With respect to payments for which an information return is required but for which withholding is not usually required, 15% of the amount of such payments are required to be withheld by the payor if the payee fails to provide an identifying number or the payor is notified by the IRS that the number provided is incorrect. Numbers with the wrong number of digits, which contain sequential digits, or which contain digits which are all the same are presumed incorrect.

INFORMATION REPORTING PROVISIONS
3.04 Returns of Brokers
I.R.C. §§ 6045, 7609 - TEFRA § 311.

Effective on the date of enactment, TEFRA requires that brokers furnish statements to their customers, as well as to the IRS, detailing information about the brokers' transactions made on behalf of their customers. The information which must be included is that which the IRS deems necessary and which it must specify in regulations within six months. TEFRA specifically authorizes the IRS to issue regulations which require brokers to report the gross proceeds as well as, or as an alternative to, the reporting of profit and loss on such securities transactions.

The definition of the term "broker" is expanded by TEFRA to include a dealer, a barter exchange, and any other person who, for a consideration, regularly acts as an intermediary with respect to property or services. The reporting requirements apply when the broker is acting as a principal for his or her own account in a transaction with a customer as well as when the broker is acting as an intermediary for a third party and a customer.

3.05 Independent Contractors and Direct Sellers
I.R.C. §§ 6041A, 6678 - TEFRA § 312.

TEFRA requires that businesses report the name, address and identifying number of every person who provides them services and to whom they pay compensation which is not subject to the wage reporting rules, but which aggregates to an annual total of at least $600 (i.e., independent contractors). The reports are required to be sent both to the IRS and to the recipient of such compensation, and of course they must specify the total amount of the compensation that was paid during the calendar year then ended. The recipient of compensation is to receive his or her report on or before January 31 of each year.

Also, any trade or business which sells $5,000 or more of consumer products in a calendar year to generally any party (other than a permanent retail establishment) is required to file an information return with the IRS setting forth the name and address of any such buyer. Curiously, however, they do not have to set forth the amount of such annual sales or the buyer's identifying number. The reporting requirement applies only if the consumer products are sold to such person on a buy-sell, deposit-commission, or other similar basis. The seller in such a case must also furnish to the buyer each year on or before January 31 his or her name and address, which, for whatever reason it is required, will alert the buyer to the fact that the buyer's name has been brought to the attention of the IRS.

In both situations above, the person about whom a report must be filed with the IRS is required to furnish the reporting party the necessary information, though no penalty is specified for any taxpayer who fails to comply. A failure to report to the IRS, on the other hand, will be subject to the general penalties for failure to report information. (See section 3.15, below).

3.06 Tip Income
I.R.C. § 6053 - TEFRA § 314.

Concerning the reporting of tip income, the battle was between the consumers of business meals and those who served them. Predictably, the latter group lost. Thus, TEFRA in its final form did not cut in half the amount of deductions allowed for business meals, as the Senate had originally agreed to do, but instead required that "large food and beverage establishments" report annually to the IRS certain information upon which the Service will base its estimate of the amount of taxable tips which were earned by the restaurant's employees.

A "large food and beverage establishment" is one which generally employs more than ten employees on a typical business day, which provides food or beverage for consumption on the presmises, and in which tipping is a customary practice. Such establishments must annually report the following information to the IRS:

(1) gross food and beverage sales receipts (excluding carryout receipts);
(2) aggregate charge receipts;
(3) employee-reported tip income;
(4) total charge slip tips; and
(5) the amount of tips allocated to each employee.

The total amount of tips allocated to each employee must equal 8% of the large establishment's gross receipts less the amount of tips which were actually reported by the employees. Such allocation, however, is not required if the employees voluntarily agree to report aggregate tips to the employer at least equal to 8% or the employer demonstrates to the Service's satisfaction that a lower amount of tips, not less than 5% of gross receipts, is generally earned by his employees and he allocates such amount.

The allocations, which are required as of April 1, 1983, may be made on the basis of a good-faith agreement between employer and employee or on the basis of the IRS regulations, to be prescribed if such an agreement is not reached. The allocation should represent each employee's proportionate share of the total amount of tips received by all of the employer's tipped employees, but the employer will incur no penalty or liability for erroneous allocations.

The amount of the allocation itself will have no effect on the amount of income or Social Security taxes which the employer must withhold from the employees tips and wages. These provisions remain unaltered. If, however, the employer avoids making the allocation by securing an agreement from his employees that they will report tips equal to at least 8%, the amount of withholding tax will be based on such amount under the provisions of existing law.

The employer must report the allocated amount to the employee as well as to the IRS by January 31. The provisions do not specify what use the Treasury will make of such information with respect to the employee's tax liability, but it is suggested in the Conference Committee Report, which provides that "an employee who reports less than his allocated amount of tips must be able to support his reporting position . . . ." From this it could be logically inferred that a rebuttable presumption of income at least equal to the allocation is thereby created.

Finally, the Treasury Department has been instructed to prepare a study of tip reporting by December 31, 1986, analyzing the effects of this compliance provision.

3.07 State and Local Income Tax Refunds
I.R.C. § 6050E - TEFRA § 313.

For calendar years after 1982, state and local government authorities must file information returns with the IRS and the recipientn of any credit, refund, or offset of income tax of ten dollars or more.

3.08 Interest Reporting
I.R.C. § 6049 - TEFRA § 309.

For information-reporting purposes, TEFRA conforms the definition of the term "interest" with the definition of that term for withholding purposes. The definition is expanded to include amounts paid on funds held by investment companies, pooled funds, and trusts, and is limited to exclude interest paid on obligations which are held by a corporation, with a maturity at issue of not more than one year. It does not include interest paid on obligations issued by natural persons or interest paid on tax-exempt obligations. It does include any other amounts which the IRS indicates in its regulations should have been considered by Congress.

Any amount of original issue discount which is amortized into income is interest which must be reported under this provision. As under prior law, information reports are not required if the amount of interest paid is less than ten dollars, unless income tax was withheld under the provisions set forth herein in section 3.01. Under TEFRA, the form of such report is modified to include a statement of the amount of such tax that was withheld so the taxpayer and the IRS can determine the amount of credit against tax to which the taxpayer may be entitled.

In January, 1983, the IRS announced that it was delaying these provisions until July 1, 1983.

3.09 Foreign Owned U.S. Corporations
I.R.C. § 6038A - TEFRA § 339.

TEFRA requires that foreign corporations doing business domestically and domestic corporations, the voting power of which is more than 50% controlled by a foreign person, must annually furnish such information relating to any and all members of the control group as the Secretary of the Treasury may require by regulation.

Examples of relevant information include the related corporation's name and principal place of business, the nature of that business, the country of its incorporation and of its residence, its relationship to the reporting corporation, its transactions with the reporting corporation, and its transactions with the reporting corporation during the preceding year. The specific information which is required to be reported is to be prescribed by the IRS by regulation.

If there is a failure to report the required information, a $1,000 penalty will be imposed unless a reasonable cause is posited for such failure. The maximum penalty to be imposed is $25,000, which is to be accumulated in $1,000 increments for each thirty-day period which elapses without compliance after the first ninety-day period of such noncompliance. The time for filing is also to be prescribed by regulation.

3.10 Foreign Personal Holding Companies
I.R.C. §§ 6035, 6679 - TEFRA § 340.

TEFRA modifies the existing reporting requirements with respect to foreign personal holding companies in the following ways:

(1) Only annual and not monthly information returns are now required.
(2) The filing requirements are now incumbent upon all shareholders who own at least 10%, instead of 50%, of the foreign personal holding company.
(3) The IRS is empowered to issue regulations excusing all but one shareholder from furnishing corporate information if more than one would otherwise be required to furnish such information.
(4) A $1,000 penalty is imposed for failure to comply with this provision.

As under prior law, the returns required to be filed by the shareholders, officers and directors who are United States citizens or residents and thus governed by the law must include information as to the names, addresses and holdings of the holders of securities issued by the foreign personal holding company, as well as details about the company's gross income, credits, taxable income and undistributed income for the preceding year.

PENALTY PROVISIONS

3.11 Substantial Understatements of Tax Liability

I.R.C. §§ 6653, 6661, 6701, 7206 - TEFRA §§ 323-325, 329.

Penalty Imposed on Taxpayers

A penalty equal to 10% of the amount of "any substantial understatement of income tax" is imposed on unextended tax returns due after 1982. A reported liability is substantially understated if it is shown to have been understated by the greater of 10% or more of the amount that should have been reported or by $5,000 ($10,000 for corporations other than Subchapter S corporations and personal holding companies).

The amount of the understatement on which the 10% penalty is based, however, is reduced to the extent that the taxpayer had reason to believe that there is or was "substantial authority" for the position taken on his or her tax return. The exact conditions under which a penalty will not be imposed vary, depending upon whether the item in question represents a tax shelter item or a non-tax shelter item.

Although TEFRA does not define the term "substantial authority," it defines a "tax shelter" item, generally, as any arrangement the principal purpose of which is the evasion or avoidance of tax. The Conference Committee Report provides only negative guidance on the issue of substantial authority. It suggests that a court will not be bound in making such a determination by the conclusions drawn by the IRS in private letter rulings, determination letters, or technical advice memoranda, nor by law review articles or opinion letters issued by tax counsel. The Report suggests instead that the court should examine the authority underlying such conclusions. The standard is more stringent than a "reasonable basis" standard but less so than a "more likely than not" standard. Both concepts can be expected to be points of considerable contention.

In the case of a non-tax shelter item, the penalty base may be reduced if, in the alternative, the taxpayer adequately disclosed in his or her return or accompanying schedules all the facts relevant to a determination of the validity of the item under question. In the case of a tax shelter item, on the other hand, the penalty base reduction will not be allowed unless, in addition to substantial authority, the taxpayer "reasonably believed" that the treatment he or she accorded the questioned item on the return was "more likely than not" correct. The "adequate disclosure" criteria is not an alternative that is available when a tax shelter item is involved.

The IRS is given authority to regulate what degree of disclosure will be adequate to affect a penalty base reduction and to waive, on a case by case basis, any or all of the penalty if it is demonstrated to the Service's satisfaction that the understatement was due to at least a reasonable cause and that the taxpayer acted in good faith.

Penalty Imposed on Aiders and Abettors

In addition to the existing return preparer criminal sanctions, TEFRA imposes a $1,000 per taxpayer penalty ($10,000 if a corporate taxpayer) upon any person who is involved in the preparation or presentation of a false or fraudulent document. The penalty is not imposed on a per document basis, but on whether the taxpayer knew or did not know of the understatement giving rise to the penalty.

The penalty will be imposed upon anyone who aids, assists, advises or procures the preparation or presentation of a return or other document, who knows that such document will be used in connection with a material matter arising under the tax laws, and who knows that its use will result in an understatement of another's tax liability. ("Procures" means to order or to know of and not attempt to prevent a subordinate from participating in such action.) The penalty may be imposed in addition to the existing criminal penalties, but only, at the IRS's discretion, as an alternative to the existing return preparer penalties.

Fraud Penalty

The fraud penalty for underpayment of tax will now include, in addition to 50% of the amount of the fraudulent understatement of tax, an amount equal to 50% of the interest due on the amount of such underpayment. The $5,000 penalty of prior law imposed for willfully filing a false document under penalty of perjury, aiding or abetting in the preparation of a false or fraudulent document, or executing such a document, is increased to $100,000 for individuals and $500,000 for corporations.

IRS Views

In a speech made in early 1983, IRS Chief Counsel Kenneth W. Gideon commented that the new understatement penalties will be vigorously imposed by the Service. In expressing his personal opinion on the penalty, he commented that he does not anticipate that taxpayers will be allowed to use amended returns to reduce or avoid the penalty or that the penalty will not apply to items just because they are treated in a manner consistent with the treatment accorded them on a prior year's return.

3.12 Abusive Tax Shelters
I.R.C. §§ 6700, 7408 - TEFRA §§ 320, 321.

The penalty may be imposed on any person who organizes, assists in the organization of, or participates in the sale of any interest in any plan or arrangement and who makes a statement with respect to such plan or arrangement which he or she knows or has reason to know is false or fraudulent, concerning the availability of any tax benefit by reason of another person's participation in such plan or arrangement. The penalty may also be imposed against organizers and others who make a gross valuation overstatement. Such an overstatement is defined as an overvaluation of 200% or more on property, the value of which directly relates to the amount of any promised tax benefit.

The penalty is equal to the greater of $100 or 10% of the gross income derived by the promoter from his or her fraudulent activity and it may be imposed in addition to any and all other applicable penalties. The IRS may again, however, wavie such penalty if it is shown that the promoter acted in good faith and the valuation was reasonably based; or the IRS may bring a civil action to enjoin the promotion of such fraudulent activity.

The definition of the term "tax shelter" is not particularly significant to this provision as long as a plan or arrangement with a promised or actual tax effect is being promoted and it does not necessarily parallel the definition of "tax shelter items" given in the preceding section.

3.13 Frivolous Returns
I.R.C. § 6702 - TEFRA § 326.

In addition to any other penalty imposed by law, taxpayers are now subject to a $500 penalty if they file a frivolous return, whether or not such return actually contains an understatement of liability or results in an underpayment of tax. The penalty is immediately assessable upon the filing of such a return.

A frivolous return is one which does not contain information on which the return's substantial correctness can be determined or one which contains information which on its face indicates that the self-assessment is incorrect. The penalty is imposed if the taxpayer's actions in filing such a return are merely frivolous or are interposed for the purpose of delaying the administration of the tax laws. The Senate Finance Committee Report suggests that this provision is intended to combat the recent wave of tax protest returns such as those which are not in processible form or which present frivolous constitutional arguments.

3.14 Estimated Tax Returns
I.R.C. §§ 6015, 6073, 6153, 6654, 7203 - TEFRA §§ 327, 328, 329.

Existing law imposes a criminal penalty of $10,000 on any person who wilfully fails to comply with existing laws respecting the filing of estimated tax returns and the payment of estimated tax. TEFRA increases this penalty to not more than $25,000 and to not more than $100,000 in the case of a corporation, and makes it inapplicable to any taxpayer who is not also subject to the civil penalty for such failure. This amendment pertains to offenses committed after the date of the enactment of TEFRA.

In addition, TEFRA eliminates the requirement that individuals file a return with the payment of their estimated tax but allows that all other laws with respect to such tax shall operate unchanged. Finally, there is provided for the first time specific statutory authority for the generally accepted proposition that taxpayers who showed no tax liability on their preceding year return are excepted from paying any estimated taxes in the current year, if the proceeding year's return covered a full twelve months.

3.15 Failure to File Information Returns or Supply Identifying Number
I.R.C. §§ 6651, 6652, 6676, 6678 - TEFRA §§ 315, 316, 318.

The penalty for failing to file an information return with respect to certain deferred compensation plans and certain term annuity and bond purchase plans is increased to twenty-five dollars per day while the failure continues, but not to exceed $15,000. In addition, the penalty for failure to provide other information returns, including the new returns required for or from brokers, independent contractors, direct sellers and interest and dividend withholding (*See* herein sections 3.04, 3.05 and 3.08), is increased from ten to fifty dollars per return, up to $50,000 (up from $25,000) per calendar year.

When the failure to file is due to intentional disregard of the filing requirements, the penalty will be not less than 10% of the aggregate amounts not properly reported (5% in the case of returns to be filed by brokers and $100 in the case of direct sellers) and the $50,000 limitation will not apply.

The civil penalty for failing to supply one's taxpayer identification number to another person or to include another person's identification number on any information report or document on which it is required is increased to $50 per failure, not to exceed $50,000 for all such failures in a calendar year. If the number provided is obviously incorrect, the taxpayer will also be subject to the 15% withholding discussed herein at section 3.03. The penalty for a failure to supply one's own identifying number on any return, statement, or document, however, remains at five dollars per failure.

After 1982, if a failure to file a due income tax return, without regard to extensions, continues for sixty days after the last extended due date, and there is an underpayment of tax, a penalty of $100 will be imposed.

3.16 Increases in Certain Criminal Fines
I.R.C. §§ 7201, 7206 - TEFRA § 329.

The maximum penalty for a willful and fraudulent attempt to evade or defeat any tax is increased from $10,000 to $100,000 for individuals and to $500,000 for corporations. The maximum penalty of $1,000 under prior law for the willful delivery of a false or fraudulent document to the IRS is increased to $10,000 for individuals and to $50,000 for corporations.

MISCELLANEOUS PROVISIONS

3.17 Obligations Required to be Registered
I.R.C. § 103, 163, 165, 312, 1232 - TEFRA § 310.

In order to restrict the number and amount of long-term bearer obligations which are issued, TEFRA imposes sanctions against those who issue such obligations other than those in registered form after 1982, and against those who purchase such obligations. An obligation is in registered form if the right to its principal and interest cannot be transferred except through an entry on the books of the issuer under a system to be specifically prescribed by future IRS regulations.

The registered form is required for all debt instruments except (1) those with a maturity at issue of less than one year, (2) those of a type not issued to the public, (3) those issued by a natural person, and (4) those issued outside the United States, the interest on which may only be paid outside the United States and which may only be sold or resold to persons who are not United States persons.

The exemption from tax for the interest income earned on otherwise tax-exempt state and local obligations is forfeited if such obligations are not issued in registered form. Also, issuers of unregistered obligations will be denied any deduction for interest payments or amortization of original issue discount on such bonds and any reduction of corporate earnings and profits otherwise available as a result of such payments and amortization. Finally, an excise tax of 1% of the unregistered obligation's face value for each year or portion thereof of the obligation's stated term will be imposed against issuers who violate this provision.

3.18 Partnership Audits and Litigation
I.R.C. §§ 6221-6232 - TEFRA §§ 401-406.

Under prior law, partnership income and expense items were passed through to the partners who individually determined the appropriate tax treatment to be accorded the item on their return. Audits by the IRS of one partner's return, and the settlement of any dispute concerning an item of partnership income resulting therefrom, had no impact upon the treatment of the same item on another partner's return. The same applied to litigation concerning such items unless such other partner was also a party to the case. This situation has resulted in a backlog of partnership cases in the Tax Court and in an impediment to the IRS's ability to make final assessments, before the period of limitations expires, against all the partners of a partnership in which a questionable item has been uncovered.

To avoid these difficulties, TEFRA makes the following changes:

(1) Each partner is required to treat items of partnership income and expense in a manner consistent with the treatment accorded such item

on the partnership return.

(2) Audits must be performed at the partnership level if the IRS wishes to challenge any particular partner's treatment of a partnership item which is consistent with the treatment of such item on the partnership return. Notice must be given, generally, to every partner and, when given, the results of such audits will be binding on all partners regardless of whether they personally participated in such proceedings, as is their right, unless challenged in court.

(3) In any partnership audit and/or settlement proceeding, a tax matters partner will be designated, in accordance with forthcoming IRS regulations, to act as a liaison between the IRS and any of his or her partners who hold less than a 1% interest in the partnership profits. Only the tax matters partner may bind any other partner to a settlement.

(4) During the first ninety days following an IRS notice of deficiency, only the tax matters partner may institute a court action challenging the IRS's position. If no such action is taken, any partner may institute such a challenge up until the 150th day following the receipt of the deficiency notice. Ultimately, however, only one action may proceed in the courts, and the results of such action will be binding on all the partners regardless of whether they personally appeared as a party thereto.

(5) These provisions do not apply to partnerships with fewer than ten partners all of whom are natural persons.

3.19 Award of Attorney's Fees
I.R.C. § 7430 - TEFRA § 292.

With respect to civil litigation instituted after February 28, 1983 but before 1986, a prevailing taxpayer may be awarded up to $25,000 of reasonable litigation costs, including attorney's fees, if such taxpayer establishes that the position advanced in the case by the United States was unreasonable.

3.20 Interest on Underpayments and Overpayments of Tax
I.R.C. §§ 6601, 6611, 6621, 6622 - TEFRA § 344-346.

Interest on underpayments and overpayments of tax accruing after 1982 must be compounded daily. Also, TEFRA requires the IRS to adjust the rate of interest paid on such amounts semi-annually, instead of annually, starting in 1983, and it limits the period for which such interest must be paid to a taxpayer in the case of late returns, returns lacking information sufficient to allow processing, and returns claiming a refund with respect to a carryback amount. With respect to this last point, the rules are generally amended so that the IRS does not have to pay interest for any period prior to the time that it first received notice of the claim for a refund.

4.00 EXCISE TAX PROVISIONS

4.01 Air Travel

I.R.C. §§ 4041, 4261, 4262, 4271, 6427, 7275 - TEFRA §§ 279, 280.

The passenger ticket tax is increased from 5% to 8%. A 5% air freight waybill tax is reimposed, as is a three dollar international departure ticket tax. Fuel taxes paid by non-commercial aviators are created and/or increased. These taxes are effective from September 31, 1982 until December 31, 1987.

4.02 Telephone Service
I.R.C. §§ 4251 - TEFRA § 282.

Along with the recent antitrust settlement which will result in the divestiture of AT&T's operating companies and an anticipated ten to forty dollar increase in the cost of residential service over the next five years, both individuals and corporations will now be saddled with a 3% (up from 1%) tax on the value of telephone services rendered after 1982 but before 1986.

4.03 Cigarette Sales
I.R.C. § 5701 - TEFRA § 283.

The tax on cigarettes is doubled to $.16 per pack beginning January 1, 1983. The tax will return to $.08 per pack on October 1, 1985.

5.00 MISCELLANEOUS PROVISIONS

5.01 Amortization of Original Issue Discount
I.R.C. §§ 163, 1232, 1232A, 1232B - TEFRA §§ 231, 232.

On Bonds and Debt Obligations Generally

The discount represented by the excess of the face value of a corporate bond or note at maturity over its original purchase price is recognized under prior law as income to the holder and expense to the issuer on a straight-line basis over the entire life of the indebtedness. On bonds and notes issued by noncorporate debtors, discount is only taken into income upon disposition and into expense upon payment.

Effective for all instruments issued after July 1, 1982, except those issued by natural persons, short-term federal obligations and state and local tax-exempt obligations, TEFRA replaces this linear formula with an accrual recognition formula which is based on the overall yield of the bond, and is intended to approximate the way in which daily compounded interest actually accrues on bonds; i.e., geometrically.

The holder's basis is adjusted upward for the sum total of all daily interest increments which are annually recognized as income up to the time of sale or maturity. This discount amortization must be recognized annually even by cash basis taxpayers though such taxpayers may still apply the cash basis method to the actual stated rate payments made or received in a tax year. The adjusted basis is used to calculate gain or loss on sale.

None of these provisions apply to bonds issued at a premium, to bonds issued to section 818(b) life insurance companies, or to corporate bonds which are not capital assets in the hands of the holder.

On Coupon Bonds

The new rules also apply to coupon bonds and to any coupon which is stripped from a bond, or vice versa, and sold after July 1, 1982. The discount on such coupon and/or bond is the excess of the stated redemption price at maturity over the fair market value of the item at the date of purchase, and it is to be amortized into income as if issued on such date.

In addition the seller, in determining the amount of gain, must allocate his or her basis in the coupon bond, adjusted to the date of sale for the daily interest increments, to *each* of the coupons remaining before the sale, and to the bond, on the basis of their fair market value on the date of the sale. The holder must then redetermine, by reference to such value, the discount for each coupon and/or bond not sold and amortize each into income as if he or she had purchased at such discount on that date.

The intention is to preclude the creation of an artificial loss through the sale of the detached bond.

5.02 Illegal Payments to Government Officials
I.R.C. § 162 - TEFRA § 288.

Effective for payments made after the date of TEFRA's enactment, only payments made to foreign government officials which are illegal under the provisions of the Foreign Corrupt Practices Act will be disallowed as a deductible business expense. Therefore, payments which are illegal under foreign law or other federal statutes will still be allowed as business deductions.

5.03 Additional Funding to the IRS
I.R.C. § none - TEFRA § 325.

Congress has appropriated additional funds for the IRS to increase its staff with a view to securing $3 billion in additional revenues through stricter compliance enforcement. One can only wonder what amount of increased revenues above and beyond this $3 billion the mere promise of increased enforcement will generate.