REPORT #549

TAX SECTION

New York State Bar Association

1986 Tax Reform Act Seminars

November 6, 1986

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REPORT =549

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

1986 Tax Reform Act Seminars

SESSION FIVE: EFFECT OF THE 1986 ACT ON THE CORPORATE TAX BASE

Chair: Ruth G. Schapiro
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Panel: Melbert E. Schwarz
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Lewis & Cohen

November 6, 1986

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TAX REFO-RE ACT OF 1986

DEPECIATION, INVESTMENT CREDIT
AND CERTAIN ACCOVNTING PROVISIONS

Richard J. Bronstein

I. Accelerated Cost Recovery System ("ACRS").[1/] Depreciation deductions in any taxable year are based on the "applicable recovery period," "applicable depreciation period" and "application convention." Section 168(a).[2/]

A. Prior law recovery periods were 3, 5 and 10 years for most personal property, 10 years for certain utility property and 19 years for real property. Recovery periods are now 3, 5, 7, 10, 15 and 20 years for personal property, 27.5 years for residential rental property and 31.5 years for nonresidential real property. Section 168(c).

1. Personal property is classified according to its ADR mid-point as follows (section 168 (e)):

Recovery Period	ADR Mid-point (in years)
3	4 or less
5	more than 4 but less than 10
7	10 or more but less than 16
10	16 or more but less than 20
15	20 or more but less than 25
20	25 or more

1/ This discussion of available depreciation deductions applies only to the regular income tax. For alternative minimum tax purposes, depreciation is computed differently.

2/ Section references, unless indicated otherwise, are to the Internal Revenue Code of 1986, which reflects the Tax Reform Act of 1986 ("TRA 1986"). References to "old" sections are to the Internal Revenue Code of 1954 prior to any changes made by TRA 1986.

2. Special rules are provided for certain types of property; property that has no ADR mid-point is treated as 7-year property. Section 168(e)(3).

3. A taxpayer can elect to apply an alternative depreciation system under section 168(g)(7). See paragraph E below.

B. Under prior law, the depreciation method was based on statutory percentages for different recovery classes. In general, depreciation is now based on the 200% declining balance method, switching to the straight line method at the time that such method yields a larger deduction. Section 168(b)(1).

1. The depreciation method for 15-year and 20-year property is the 150% declining balance method, switching to the straight line method. Section168(b)(2).

2. The depreciation method for residential rental and nonresidential real property is the straight line method at all times. Section 168(b)(3).

3. A taxpayer may elect to apply the straight line method to any class of property. Section 168(b)(5). In the case of an affiliated group, it is not clear whether this election is to be made on a group or on an individual corporation basis.

4. Salvage value is treated as being equal to zero. Section 168(b)(4).

C. The applicable convention is generally the half-year convention, under which property placed in service (or disposed of) in any year is treated as being placed in service (or disposed of) at the mid-point of such year. Section 168(d)(1).

1. For residential rental and nonresidential real property, the applicable convention is the mid-month convention, under which property placed in service (or disposed of) in any month is treated as being placed in

service (or disposed of) at the mid-point of such month. Section 168(d)(2).

2. Note that the half-year convention and 200% declining balance method often provides more generous deductions in early years than prior lax (which was based on the 150% declining balance method).

   a. For example, for 5-yeer property the first-year deduction is now 20% of depreciation basis (rather than 15%), and the second-year deduction is 32% (rather than 22%). Even for 5-year property that is now seven-year property, the deductions in the first two years are 14.3% and 24.5% of depreciation basis, compared to 15% and 22%.

   b. Under prior law, however, 5-year property was fully depreciated in the fifth taxable year in which depreciation deductions were allowable; under section 168, the switch to the straight-line method leaves a half-year of depreciation deductions to be claimed after the fifth year, and property is not fully depreciated until the sixth year.

3. A significant exception to the half-year convention is a new mid-garter convention, which applies in any taxable year in which the aggregate bases of property placed in service in the last quarter of such year is greater than 40% of the aggregate bases of all property placed in service in such year. Section 168(d)(3). Under the mid-quarter convention, property placed in service (or disposed of) in any quarter of a taxable year is treated as being placed in service (or disposed of) at the mid-point of such quarter.

   a. The 40% test is applied by taking into account all property to which old and new section 168 applies, but without regard to nonresidential real and

residential rental property. Section 168(d)(3)(B); Conference Report, p. 47. Although property to which new section 168 does not apply is taken into account in applying the 40% test, such property is not subject to the mid-quarter convention.

b. The 40% test treats all members of an affiliated group as a single taxpayer. Conference Report, p. 47.

c. The 40% test and mid-quarter convention was intended to reduce the incentive to place large amounts of property in service near the end of a taxable year. This policy decision is itself questionable, and these rules do not necessarily achieve the intended objective. Indeed, there is often a benefit from the application of these rules. If a taxpayer places in service

$60 of 5-year property in the first quarter of its taxable year and $50 of 5-year property in the last quarter of its taxable year, the first-year depreciation deduction under the half-year convention would be $22, but the first-year deduction under the mid-quarter convention is $23.50. Moreover, if the last-quarter property were not subject to new section 168, the aggregate first-year deduction would be $28.50 under these rules, compared to $19.50 without regard to these rules.

D. The anti-churning rules are retained, and old section 168(e)(4) still applies. In addition, if property would be described in old section 168 (e)(4) if such section were applied by substituting 1987 for 1981 and 1986 for 1980, new section 168 does not apply to such property, unless the first-year deduction under old section 168 would be greater than the first-year deduction under new section 168. Section 168(f)(5).

E. An alternative depreciation system applies to property that is used predominantly outside the United States, tax-exempt use property, tax-exempt bond financed property, imported property covered by an Executive Order, and property for which the taxpayer elects to apply the alternative depreciation system. Section 168(g)(1).

   1. Depreciation under the alternative depreciation system is generally based on the straight line method over the ADR mid-point (or 40 years for nonresidential rental and residential real property and 12 years for property with no ADR mid-point). Section 168(g)(2).

a. For tax-exempt use property subject to a lease, the depreciation period is the longer of the ADR mid-point and the lease term. Section 168(g)(3). In measuring the lease term for this purpose, all renewal options are taken into account, except that for residential rental and nonresidential real property, an option to renew at fair market value is disregarded. Section 168(i)(3).

2. In determining whether property is used predominantly outside the United States, the rules in section 48(a)(2)(B) apply. In addition, a satellite or other spacecraft held by a United States person and launched from the United States is not treated as used predominantly outside the United States. Section 168(g)(4)

    a. Under prior law, property that was used predominantly outside the United States was depreciated under the 200% declining balance method, and the change to the straight line method represents a significant change.

3. The definition of tax-exempt use property is substantially the same as under prior law. Section 168(h).

4. Tax-exempt bond financed property is defined as any property to the extent that such property is financed with tax-exempt bonds. Section 168(g)(5).

5. An election to apply the alternative depreciation system may be made on a class-by-class basis for most property, but on a property-by-property basis for residential

rental and nonresidential real property. Section 168(g)(7). In the case of an affiliated group, it is not clear whether this election is made an individual corporation or on a group basis.

6. For earnings and profits purposes depreciation is based on the alternative depreciation system. Section 312(k)(3).

F. Prior to TRA 1986, in various tax-free transactions and in sale-leaseback transactions more than 12 months after the property was placed in service by the transferor, the transferee "stepped in to the shoes" of the transferor. Old section 168(f)(10); Prop. Regs. § 1.168-5(b).

1. Similar rules still apply to transactions described in sections 332, 351, 361, 371(a), 374(a), 721 and 731, but not to sale-leaseback transactions. Section 168(i)(7).

2. Under Section 1809(b)(1) of TRA 1986, a "technical correction" amends old section 168(f)(10) so that its application to sale-leaseback transactions after December 31, 1985 is limited to causing the transferee to be bound by any election made with respect to the property.

3. Section 168(1)(7) and old section 168(f)(10)do not apply to partnership terminations under section 768(b)(1)(B) after December 31, 1985. Section 168(i)(7)(B); TRA 1986, Section 1809(b)(2).

G. A lessee is entitled to depreciate the cost of leasehold improvements under section 168; the only applicable amortization for lessees is leasehold acquisition costs. Section 178.

H. There is no depreciation recapture for residential rental and nonresidental real property, presumably because such property is depreciated under the straightline method.

I. In general, new section 168 applies to property placed in service after December 31, 1986, but a taxpayer may elect to apply new section 168 to property placed in service after July 31, 1986 and before January 1, 1987. Numerous generic and specific transition rules are contained in Sections 203, 202 and 251(d) of TRA 1986. The significant generic rules are briefly summarized be1ow.

1. The transition rules generally do not apply unless property has an ADR mid-point of at least 7 years and is placed in service before January 1, 1989 (if the ADR mid-point is at least 7 years but less than 20 years) or January 1, 1991 (if the ADR mid-point is more than 20 years).

2. New section 168 does not apply to property that is constructed, reconstructed or acquired pursuant to a written contract that was binding on March 1, 1986. TRA 1986, Section 203(b)(1)(A). If the property or the contract is transferred, new section 168 "does not apply to the property in the hands of the transferee, as long as the property was not placed in service by the transferee before the transfer by the transferor." Conference Report, p. 55.

3. New section 168 does not apply to property constructed or reconstructed by the taxpayer if the lesser of $1 million or 5% of the cost of the property was incurred or committed by the taxpayer by

March 1, 1986, and if the construction or reconstruction began by March 1, 1986. TRA 1986, Section 203(b)(1)(B)

4. New section 168 does not apply to an "equipped building" or "plant facility if construction commenced by March 1, 1986 pursuant to a written specific plan and more than one-half of the cost of the property was incurred or committed by March 1, 1986. TRA 1986, Section 203(b)(1)(C)

5. New section 168 does not apply to property if (a) the property is acquired from a taxpayer in whose hands new section 168 would not have applied, (b) the property is leased back to "such taxpayer" and (c) the leaseback occurs within three months after the property was originally placed in service. TRA 1986, Section 203(b)(3).

II. The regular 10% investment credit has been repealed for property placed in service after December 31, 1985. Section 49(a).

A. The principal exception to this repeal is for "transition property." Section 49(b)(1). In general, transition property is defined as property to which new section 168 would not apply if the relevant date for the ACRS transition rules were December 31, 1985 instead of March 1, 1986; in addition, certain property with an ADR mid-point of less than 7 years is eligible as transition property if placed in service by specified dates. Section 49(e)(1).

B. For taxable years beginning after June 30, 1987, any regular investment credit for transition property and any investment credit carryover attributable to the regular investment credit is reduced by 35%. Sections 49 (c)(1) and (2)

1. The 35% reduction is phased in with the corporate rate reduction, so that for taxable years beginning before July 1, 1987 and ending after June 30, 1987, there is a partial reduction in an amount that reflects the extent of the phase-in of the tax rate cut.

C. The depreciation basis of any property placed in service after December 31, 1985 is reduced by the full investment credit claimed with respect to such property, after taking into account the reduction referred to in paragraph B above. Section 49(d)(1); Conference Report, p. 63.

D. Qualified progress expenditures claimed for periods prior to January 1, 1986 are not affected by the repeal of the investment credit. Section 49(b)(2).The investment credit for qualified progress expenditures for periods after December 31. 1985 has been repealed, unless it is reasonable to expect that the property will be transition property when it is placed in service. Section 49(e)(2).

E. For regular income tax purposes, the investment credit in any taxable year is limited to $25,000 plus 75% of regular tax liability in excess of $25,000. Section 38(c)(1). The limitation in old section 38 (c)(1) was 85%.

F. There is no change in the availability of an election to treat the lessee as having acquired leased property for investment credit purposes (i.e., the “ITC pass-through election”). Section 48(d). The credit is, however, subject to the 35% reduction described in paragraph B above.

III. Certain Accounting Provisions.

A. In general, the cash method of accounting may not be used by any C corporation, by any partnership that has a C corporation as a partner or any tax shelter (as defined in section 461(i)). Section 448(a).

   1. Exceptions to this rule are provided for farming businesses, qualified personal service corporations, and entities with average annual gross receipts of up to $5 million, but not for tax shelters. Section 448(b).

   2. The requirement of using the accrual method of accounting does not apply to loans, leases, transactions with related parties and certain real estate contracts entered into before September 26, 1985. TRA 1986, Sections 801(d)(2) and (3).

   3. The accrual requirement is generally effective for taxable years beginning after December 31, 1986. TRA 1986, Section 801(d)(1). A change in method of accounting required by TRA 1986 will be treated as initiated by the taxpayer with the consent of the Secretary of the Treasury, and any adjustment required by section 481 as a result of such change will generally be taken into account over a period up to 4 years (or 10 years in the case of a hospital). Conference Report, p. 288.

B. TRA 1986, Section 806 generally requires that all partnerships, S corporations and personal service corporations conform their taxable years to the taxable years of their owners, unless it can be established that there is a business purpose (other than the deferral of income to the owners) in using a different taxable year.

1. In the case of partnerships, the taxable year must be (a) the taxable year of the partners owning a majority of the interests in profits and capital, (b) if there is no such year, the taxable year of all of the principal partners or (c) if there are no such years, the calendar year. Section 706(b)(1). There are certain limitations on partners changing their taxable years to enable the partnership to adopt a taxable year other than the calendar year. Section 406(b)(4).

   a. If a partnership received permission to use a fiscal year that resulted in a deferral of more than three months of income, the partnership will be allowed to continue the use of such taxable year without further approval. Conference Report, p. 319.

   b. Business purpose requirement cannot be met by establishing the use of a particular year for regulatory or financial accounting purposes, hiring patterns, use of a particular year for administrative purposes (such as the admission or retirement of partners) or compensation or retirement arrangements with partners. Conference Report, p. 319.

2. The taxable year of an S corporation must be the calendar year, unless a business purpose can be established for using a different year. Section 1378. Previously, a corporation that was an S corporation for a taxable year that included December 31, 1982 could continue to use a taxable year other than the calendar year until there was a

50-percent shift in ownership of the S corporation. Old section 1378 (c).

a. As in the case of partnerships, an S corporation that receives permission to use a fiscal year that involved a deferral of income of more than three months of income will be allowed to continue to use such taxable year without further approval. Conference Report, p. 319.

3. The taxable year of a personal service corporation must be the calendar year unless a business purpose (other than the deferral of income to shareholders) is established for having a different taxable year. Section 441(i)(l). The term "personal service corporation" is defined in a manner similar to the definition in section 269A(b)(1). Section 441(i)(2).

4. Section 806 is generally effective for taxable years beginning after December 31, 1986. To the extent that partners of partnerships and shareholders of S corporations are required to include items of income from a short year as a result of the change, such income is taken into account by the partners and shareholders ratably in each of the first four taxable years (including the short year) beginning after December 31, 1986 (unless the partner or shareholder elects to include all of the income in the short year). TRA 1986, Section 806(e).

C. Section 263A includes a new "uniform capitalization rule," which generally applies to real and tangible personal property that is produced by the taxpayer and real and persons1 property that is purchased for resale to customers and does not constitute inventory. Section 263A(b). These rules apply only to property that is used in the taxpayer's trade or business or in an activity that is engaged in for profit.

1. In general, costs associated with the production or acquisition of inventory items are to be treated as inventory costs, and the costs of constructing other assets are to be capitalized. All direct costs and "a proper share" of indirect costs, including taxes, are subject to the capitalization requirement. Apparently, the uniform capitalization rules will be based on the rules in section 1.451-3(d)(6) of the Regulations, relating to long-term contracts.

2. The IRS is authorized to prescribe a simplified method for applying the uniform capitalization rules to property that is acquired for resale. See Conference Report, pp. 305-308.

3. Under TRA 1986, section 134 the deduction for sales taxes is repealed, and instead any sales taxes paid or accrued in connection with the acquisition of property is included in the cost of the property.

4. The capitalization of interest on property produced by a taxpayer is governed by section 263A(f). These rules will replace the construction period interest and taxes amortization rules contained in old section 189, which has been repealed.

    a. Interest must be capitalized if it is incurred with respect to the construction, manufacture or improvement of self-constructed property that has a long useful life, or an estimated production period of more than 2 years (or one year in the case of property with the cost of more $1 million). Property that has a long useful life includes any real property or any other property that has an ADR mid-point of 20 years or more.

    b. The amount of interest allocated to any property is determined under the "avoided cost method", under which interest on any indebtedness directly

attributable to the property is allocated to the property, and interest on any other indebtedness is allocated to the property to the extent that the taxpayer's interest costs could have been reduced if expenditures with respect to such property had not been incurred.

5. The uniform capitalization rules generally apply to costs incurred after December 31, 1986. The rules do not apply to property that is produced by the taxpayer for use by the taxpayer, if “substantial construction” occurred before March 1, 1986.

D. Under section 460, taxpayers may elect to compute income from long-term contracts under either the “percentage of completion” method or under a new “percentage of completion-capitalized cost” method. Under the latter method, the taxpayer must take into account 40% of all items under the percentage of completion method and 60% of such items under the taxpayer's normal method of accounting and these new rules apply to contracts entered into after February 28, 1986.

E. Old sections 166(c) and (f) have been repealed for taxable pars beginning after December 31, 1986, so that taxpayers generally may not use the reserve method for computing bad debt deductions. Instead, taxpayers will generally be required to use the specific charge-off method of accounting for losses on bad debts. Any resulting change in accounting method will be treated as a change initiated by the taxpayer with the consent of the Secretary of the Treasury, and the balance of the bad debt reserve at the time of the change will be included in gross income over a 4-year period.

November 6, 1986

INSTALLMENT SALES
under the
TAX REFORM ACT OF 1986

Ruth G. Schapiro

I. Overview

A. Proportionate Disallowance Rule. Installment treatment is limited by treating a portion of the taxpayer's indebtedness as a payment on "applicable installment obligations," based on the ratio of these installment obligations to total assets.

B. Publicly Traded Property. Use of the installment method is eliminated for publicly traded property.

C. Revolving Credit Sales. Installment sale treatment is eliminated for sales pursuant to revolving credit plans.

II. Definitions

A. Applicable installment obligation (Act §811(a);[*] Code §453C(e)) means any obligation held by the seller or a member of the seller's affiliated group arising from the disposition of property after specified dates, subject to specified exceptions, as follows:

1. An installment disposition after February 28, 1986 of personal property by a person who regularly sells or otherwise disposes of personal property of the same type as that disposed of on the installment plan;

2. An installment disposition after February 28, 1986 of real property held for sale to customers in the ordinary course of business; or

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[*] Except where otherwise indicated, the provision of the Act governing the material discussed in parts II through IV of this outline is §811(a). The reference to §811(a) of the Act is not repeated in these parts; the only statutory references set forth are references to the applicable provisions of new Code §453C.

3. An installment disposition after August 16, 1986 of real property used in the taxpayer's trade or business or held for the production of rental income, where the sale price exceeds $150,000.

4. Applicable installment obligation does not include:

   a. an obligation arising from the disposition by an individual of personal use property; or

   b. an obligation arising from the sale of property used in the trade or business of farming or of property produced in the trade or business of farming; or

   c. on an elective basis (with interest payable on the deferred tax), an obligation arising from certain sales of timeshares or residential lots; or

   d. an obligation arising from the disposition of tangible personal property by a manufacturer (or an affiliate) to a dealer where (i) the dealer is obligated to pay only when the dealer resells or rents the property; (ii) the manufacturer has the right to repurchase the property at a fixed or ascertainable price after no later than the 9-month period beginning with the date of the sale to the dealer, and (iii) certain other conditions relating to the ratio of the taxpayer’s installment obligations to its sales to dealers are met (Act §811 (C)(2)).

5. The enrolling resolution as passed by the House of Representatives on September 25, 1986, would have expanded the definition of applicable installment obligations to include an obligation held by a person in whose hands the basis of the obligation is determined (in whole or in part) by reference to the basis to another person in whose hands the obligation was an applicable

installment obligation. H. Con. Res. 395, 99th Cong., 2d Sess., item (97)(1986) (hereinafter referred to as the "House Enrolling Resolution").

B. Allocable installment indebtedness (Code §453C(b)):

1. "Allocable installment indebtedness" means for any taxable year the excess, if any, of:

a. the installment percentage of the taxpayer's average quarterly indebtedness for the taxable year, over

b. the aggregate amount treated as allocable installment indebtedness with respect to applicable installment obligations which are outstanding as of the close of the taxable year and did not arise during the taxable year.

2. In computing the taxpayer's average quarterly indebtedness, indebtedness is not taken into account where substantially all of the property securing the debt is personal use property or installment obligations arising from the sale of such property.

3. If the taxpayer has no applicable installment obligations described in A1 or A2 above outstanding at any time during the taxable year, allocable installment indebtedness for the year is computed on the basis of the taxpayer's indebtedness as of the close of the year rather than the taxpayer's average quarterly indebtedness. Regulations may provide that this rule shall not apply where necessary to prevent avoidance of the proportionate disallowance rule. Code §453C(e)(5)(C).

C. Installment percentage (Code §453C(b)(2)) means the percentage (not in excess of 100 percent) determined by dividing 1 below by 2 below.

1. The face amount of all applicable installment obligations of the taxpayer

outstanding as of the close of the taxable year.

2. The sum of (i) the aggregate adjusted bases of all assets (other than installment obligations) held as of the close of the taxable year, and (ii) the face amount of all installment obligations outstanding as of the close of the taxable year.

   a. For this purpose, a taxpayer may elect to compute depreciation under the method used in computing .earnings and profits under Code §312(k) (generally the straight line method).

   b. Personal use property held by an individual is not taken into account.

   c. An installment obligation arising from the sale of such personal use property is not taken into account.

D. Personal use property (Code §453C(b)(3)), as defined in Code §1275(b)(3), means property substantially all of the use of which by the taxpayer is not in connection with a trade or business of the taxpayer or an activity described in Code §212.

III. Operation of the Proportionate Disallowance Rule

A. General Rule. The amount of the taxpayer's allocable installment indebtedness ("AII") for the taxable year is treated as a payment on the taxpayer's applicable installment obligations that arose in that taxable year and are still outstanding as at the close of the year. Code §453C(a).

1. Determination of AII. Under the definitional rules set forth in part II above, determining AII for a taxable year is a two-step process, First, the taxpayer's average quarterly indebtedness (or year-end indebtedness, where applicable) is multiplied by a fraction. The numerator of the fraction is the face amount of the taxpayer's applicable installment obligations outstanding at the end of the

year. The denominator is the sum of (a) the face amount of all installment obligations (both applicable installment obligations and other installment obligations, with the exceptions noted above) and (b) the adjusted basis of all other assets of the taxpayer. Second, any AII that is attributable to applicable installment obligations arising in earlier years is subtracted.

2. Subsequent Payments on Installment Obligations. Once AII is determined to be allocable to an installment obligation it clings to that obligation. As payments are received they are applied first against the allocable AII and serve to reduce it. They are not taken into account (i.e., do not trigger recognition of gain) until they exceed the amount treated as AII.

3. Subsequent Increases in AII. If the AII for any taxable year exceeds the amount which may be allocated to applicable installment obligations arising in that year, the excess is allocate to applicable installment obligations arising in earlier years, beginning with the earliest preceding year for which there is an applicable installment obligation outstanding. Thus, there can be an increase in the AII attributable to an outstanding installment obligation after the year of sale. Code §453C(d)(2).

   a. With respect to the rule set forth above, there is some ambiguity in the language of Code §453C(d)(2), which would have been eliminated had the enrolling resolution been passed by Congress. See House Enrolling Resolution, item (96).

4. Limitation to Contract Price. The amount of AII with respect to a particular installment obligation is limited to the total contract price (less payments received or previously deemed received). Code §453C(d)(l).

B. Examples

Example 1: In Year 1, T makes an installment sale subject to the proportionate disallowance rule for $50. At the end of Year 1, the adjusted basis of T's assets (other than the installment receivable) is $200; T's average quarterly indebtedness is $100. T has AII of $20 ($50/$250 x $100).

T does not receive any payments on the installment obligation in Year 2. A t the end of Year 2, the adjusted basis of T's assets remains $200; T's average quarterly indebtedness is $150. T has AII in Year 2 of $10 (($50/$250 x $150) minus $20).

In Year 3, T receives a payment of $25. None of the payment is taken into account since it is less than the AII ($30).

Example 2: The facts are the same as in Example 1, but at the end of Year 2, the adjusted basis of T'S assets is $150 and T's average quarterly indebtedness is $100. T has A11 in Year 2 of $5 (($50/$200 x $100) minus $20).

Example 3: In Year 1, T makes an installment sale subject to the proportionate disallowance rule for $90,000. No payments are received. At the end of Year 1, the adjusted basis of T's assets is $310,000; T's average quarterly indebtedness is $200,000. T has AII of $45,000 ($90,000/$400,000 x $200,000).

In Year 2, T makes an additional installment sale subject to the proportionate disallowance rule for $110,000. No payments are received on the installment obligation arising in Year 1 or on the installment obligation arising in Year 2. At the end of Year 2, the adjusted basis of T's assets is $400,000; T's average quarterly indebtedness is $300,000. T's AII for Year 2 is $55,000 (($200,000/$600,000 x $300,000) minus $45,000). All of the $55,000 is treated as a payment with regard to the sale made in Year 2.

In Year 3, T makes a third installment sale subject to the proportionate disallowance rule for $130,000. In Year 3, payment in full is

received with regard to the sale in Year 1. No payments are received with regard to the sales in Year 2 or Year 3. At the end of Year 3, the adjusted basis of T's assets is $360,000; T's average quarterly indebtedness is $500,000. T's AII for Year 3 is $145,000. This is calculated by multiplying $500,000 by $240,000/$600,000 (which equals $200,000) and then subtracting the AII for previous years. The AII for previous years is the AII for Year 1 reduced by the payment receive2 in Year 3 ($45,000 - $45,000 = 01, plus the AII for Year 2 ($55,000). Since the A11 for Year 3 of $145,000 exceeds the amount of the installment obligation arising in Year 3, T is treated as having received a payment of $130,000 on that obligation and a payment of $15,000 ($145,000 - $130,000) on the installment obligation that arose in Year 2.

C. Indebtedness

1. For purposes of calculating AII, all indebtedness of the taxpayer is taken into account (subject to the personal use exception). This includes accounts payable and accrued expenses. S. Rep. 99-313, 99th Cong. 2d Sess. 126 (1986) (hereinafter referred to as the "Senate Report").

2. There is no exclusion for nonrecourse debt. Thus, for example, if a taxpayer has two pieces of rental real estate, both of which are subject to purchase money nonrecourse mortgages, and sells one of the properties on the installment basis, the other mortgage serves to trigger AII. This result seems unduly harsh.

3. The legislative history indicates that there may be scrutiny of the timing of debt repayment and that a repayment determined to be for the purpose of avoiding the thrust of the proportionate disallowance rule will be ignored. Senate Report, at 127. Apparently this would not extend to month-end repayments of accrued expenses and similar items if the taxpayer regularly pays all such items at month end. Id., at 126-27.

D. Reserves. Regulations are to provide for the proper treatment of reserves, including consistent treatment of assets he12 in the reserves. Code §453C(e)(5)(B).

E. Groups under Common Control. The determination of AII is made on a group-wide basis in the case of entities and individuals treated as a single employer under Code §52 (for purposes of the targeted jobs credit). Code §453C(e)(2). See Reg. §1.52-1.

F. Partnerships and Other Pass-through Entities: Related Parties

1. The Act does not provide rules for the determination of A11 in the case of partnerships and other pass-through entities. The subject is left to regulations under a broad grant of authority to prescribe regulations "disallowing the use of the installment method in whole or in-part for transactions in which the rules of this section otherwise would be avoided through the use of related parties, pass-through entities, or intermediaries." Code §453C(e)(5)(A).

2. The regulations may provide for the aggregation of the assets and indebtedness of a partnership and its partners in determining the extent to which each partner is to report gain on installment sales. They may also provide for aggregation in the case of other related parties, such as corporations and their shareholders. H. R. Rep. 99-841, 99th Cong., 2d Sess. II-299 (1986) (hereinafter referred to as the "Conference Report").

3. Under the regulations, installment obligations may be subjected to the proportionate disallowance rule where they arise from the sale of an interest in one related party by another, to the extent sales of the assets of the other party would be subject to the proportionate disallowance rule. Any corporation, partnership or trust may be treated as related to its shareholders, partners or beneficiaries where the proportionate disallowance rule otherwise might be avoided. Conference Report, at II-298 and II-299.

4. If the assets of a business are sold on the installment basis, the proportionate disallowance rule would apply to the installment obligations arising from the sale of real property used in the business (assuming the price for the property is over $150,000). Would a sale of the stock of the corporation on the installment basis be subject to the proportionate disallowance rule, assuming the property was not contributed for the purpose of avoiding the thrust of the rule?

5. Suppose the business is in partnership form. Would a sale of the partnership interests on the installment basis be subject to the proportionate disallowance rule to the extent attributable to the interest in the real property? Would the rule apply to a sale of a partnership interest on the installment basis by one partner?

G. 1986 Planning Consideration. Where a sale of property in 1986 for deferred payments results, in long-term capital gain, it may be desirable to elect out of installment treatment in order to obtain the benefit of the lower rate on long-term gains this year. The decision turns on a present value calculation. Note that an important factor in that calculation is the potential impact of the proportionate disallowance rule, where that rule would be applicable.

IV. Sales of Timeshares and Residential Lots

A. Elective Rule. To qualify for elective treatment, the following requirements must be met (Code §453C (e)(4)(A)):

1. The installment obligation must arise from a sale in the ordinary course of the taxpayer's trade or business.

2. The sale must be to an individual.

3. The installment obligation must not be guaranteed by any person other than an individual.

a. The obligation may not be insured by any third party (including the

government) other than an individual. Senate Report, at 129.

4. The sale must be of:

   a. a timeshare right to use, or a timeshare ownership interest in, residential real property for not more than 6 weeks; or

   b. a right to use specified campgrounds for recreational purposes; or

   c. a residential lot, but only if the taxpayer (or any related person) is not to make any improvements with respect to the lot.

      (1) The legislative history indicates that the providing of common infrastructure items, such as roads and sewers, is not considered improvement for this purpose. Senate Report, at 129 n.12.

5. For purposes of the 6-week limitation referred to in 4a above, a timeshare right to use, or a timeshare ownership interest in, property held by the spouse, children, grandchildren or parents of an individual is treated as held by the individual.

B. <u>Effect of Election</u>

1. The proportionate disallowance rule does not apply. Code §453C(e)(4)(A).

2. Interest is payable on the portion of any tax for any taxable year attributable to the receipt of payments on the obligation in that year (other than payments received in the taxable year of the sale). Code §453C(e)(4)(B).

   a. The attributable portion of the tax is determined without regard to any deduction for the interest.

b. The interest is computed for the period from the date of the sale to the date on which the payment is received.

c. The rate of interest is the applicable federal rate under Code §1274 (without regard to subsection (d)(2) or (3) of §1274) in effect at the time of the sale, compounded semiannually.

d. Interest payable under this provision is treated as an addition to tax for the taxable year in which the payment is received. However, the amount of the interest is to be taken into account as interest for deductibility purposes. Code §453C(e)(4)(C).

V. Effective Date of Proportionate Disallowance Rule

A. General Rule. The changes made by Act 5811 (proportionate disallowance rule) are generally applicable to taxable years ending after December 31, 1986, with respect to dispositions after February 28, 1986 (Act §811(c)(1)), subject to certain special transitional rules.

1. Any sales of dealer property after February 28, 1986, but before the taxpayer's first taxable year ending after December 31, 1986, are to be treated as arising in the taxpayer's first taxable year ending after December 31, 1986. Conference Report, at II-300.

2. Non-dealer sales of real property after August 16, 1986, but before the taxpayer's first taxable year ending after December 31, 1986, are also treated as arising in the taxpayer's first taxable year ending after December 31, 1986. Id.

B. <u>Sales of Real Property by Dealers</u>

1. In the case of installment obligations arising from the sale of real property in the ordinary course of business, gain attributable to AII allocated to such installment obligations that arise (or are deemed to arise) in the first taxable year ending after December 31, 1985 is to be taken into account ratably over the three taxable years beginning with such first taxable year. Such gain in the second taxable year ending after December 31, 1986 is to be taken into account ratably over the two taxable years beginning with such second taxable year. Act §811(c)(6).

2. It is intended that, despite the above phase-in rule, the rules relating to the treatment of subsequent payments on applicable installment obligations are to be applied as if the provisions were fully effective in the first taxable year ending after December 31, 1986. Conference Report, at II-300.

C. <u>Sales of Personal Property by Dealers</u>

1. In the case of dealers in personal property, any increase in tax for the first taxable year ending after December 31, 1986 by reason of the amendments made by Act §811 is to be treated as imposed ratably over the three taxable years beginning with such first taxable year. Any increase in tax imposed for the second taxable year ending after December 31, 1986 by reason of the amendments is to be treated as imposed ratably over the two taxable years beginning with such second taxable year. Act §811(c)(7).

2. It is intended that the rules with regard to treatment of subsequent payments on applicable installment obligations are to be applied as if the provisions were fully effective in the first taxable year ending after December 31, 1986. Conference Report, at II-300.

VI. Publicly Traded Property

A. General Rule. Sales of publicly traded property -- i.e., stock or securities traded on an established securities market or, to the extent provided in regulations, other property of a kind regularly trade? on an established market -- may not be accounted for on the installment method. All payments to be received are treated as received in the year of disposition. Act §812(a); Code §453(j).

B. Gain Recognized on Trade Date. In the case of securities transactions on an exchange, gain is to be recognized by both cash basis taxpayers and accrual basis taxpayers on the trade date rather than on the settlement date. Senate Report, at 131.

C. Pass-through Entities; Related Parties.

1. Authority is granted for the issuance of regulations to prevent avoidance of the rule on publicly traded property or the rule on revolving credit sales (discussed below) through the use of relate5 parties, pass-through entities or intermediaries. Act §812(a); Code §453(j).

2. These regulations are to be similar to those relating to the proportionate disallowance rule. Conference Report, at II-299.

3. It is intended that the regulations will apply to sales of property where a substantial portion of the value is attributable to property the sale of which could not be reported on the installment method, for example, stock of a wholly-owned corporation the only assets of which are publicly traded securities. Senate Report, at 131.

4. The regulations would not apply where the seller could not have sold, or caused the sale of, the publicly traded securities directly, for example, a sale by a retiring partner in a large investment partnership. Id.

D. Effective Date. The Act provides that the denial of installment treatment for publicly traded property is effective for taxable years beginning after December 31, 1986. Act §812(c)(1). The Conference Report states that the provision is effective for sales of property after December 31, 1986. Conference Report, at II-301.

VII. Revolving Credit Plans

A. General Rule. In the case of any disposition of personal property under a revolving credit plan, installment treatment has been eliminated. All payments are treated as received in the year of disposition. Act §812(a); Code §453(j).

B. Meaning of Revolving Credit Plan

1. Revolving credit plan is not defined in the statute. The legislative history indicates that the term shall have the same meaning as that under present law, with a reference to Reg. §1.453-2(d). Senate Report, at 130.

2. Generally, under Reg. §1.453-2(d), the term "revolving credit plan" includes a cycle budget account, a flexible budget account, a continuous budget account and other similar arrangements for the sale of personal property under which the customer agrees to pay a part of the outstanding balance of the customer's account Suring each period of time for which a periodic statement of charges and credits is rendered.

C. Pass-through Entities; Related Parties. See the discussion at VIC above.

D. Effective Date. Act §812, denying installment treatment to revolving credit plan sales, is effective for taxable years beginning after December 31, 1980. Act §8l2(c)(1).

E. Change in Method of Accounting

1. The change in the treatment of revolving credit plans is treated as a change in method of accounting for the first taxable year beginning after December 31, 1986. Act §812(c)(2). The change is treated as

initiated by the taxpayer and as having been consented to by the Secretary.

2. The period for taking into account adjustments under Code §481 by reason of the change is not to exceed four years. Id.

VIII. Alternative Minimum Tax. In computing alternative minimum tax, use of the installment method is not permitted with respect to applicable installment obligations. All payments are deemed received in the taxable year of disposition. Act §701(a); Code §56(a)(6). The new alternative minimum tax provisions are generally effective for taxable years beginning after December 31, 1986. Act §701(f).

November 6, 1986

The Corporate Alternative Minimum Tax Under the Tax Reform Act of 1986

by

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I. Introductory.

A. Tax Reform Act. The Tax Reform Act of 1986 (the "Act") imposes a new corporate alternative minimum tax ("AMT") at a 20 percent rate. New Code Sections 53, 55-59.

B. Structure. The new corporate AMT is similar in structure to the individual AMT under current law (and under the Act), in that it is a true alternative tax on a recomputed income base. In contrast, under current law, corporations are subject to an add-on tax on items of tax preference.

C. Book Income Adjustment. The most significant provision of the corporate AMT is the "book income adjustment," discussed in Section IV infra. This provision is significant in terms of:

1. Revenue. The book income adjustment is anticipated to be the most significant source of corporate AMT revenue.

2. Novelty. Never before has tax liability been so directly tied to financial statement income. But cf. current Section 472.

3. Complexity. The book income adjustment provisions add a completely new element to the analysis of tax consequences and the calculation of tax liability. Furthermore, there are numerous unanswered questions regarding the new provisions.

D. Applicability. The corporate AMT applies to all C corporations. In the case of real estate investment trusts ("REITS") and regulated

investment companies ("RIGS"), items computed differently for regular tax and AMT purposes are apportioned between the corporation and its shareholders, so that there is in effect one level of AMT. The corporate AMT does not apply to real estate mortgage investment conduits ("REMICS") or S corporations, although the shareholders of an S corporation may be subject to the individual AMT. Kew Code Sections 59(d), 860A(s), 1363(a).

The book income adjustment provisions do not apply to REITS, RIGS, REMICS, or S corporations. New Code Section 56(f)(4).

E. Effective Date. The new corporate AMT applies to taxable years beginning after December 31, 1986. Effective dates and transition rules for specific provisions of the AXT are discussed below.

II. Operation of Corporate AMT.

A. AMT Income. The first step in computing AMT liability is to compute AMT income, which will generally be greater than regular taxable income. In some instances, the items making up regular taxable income must be recomputed. In other instances, certain defined "items of tax preference" must be added to regular taxable income. New Code Section 55(b)(2).

B. Exemption Amount. After computing AMT income, a corporate taxpayer subtracts an exemption amount. The exemption amount is $40,000, reduced by 25 percent of the amount by which AMT income exceeds $150,000. Hence, once AMT income reaches $310,000, the exemption amount is zero. New Code Section 55(d).

C. AMT Liability. AMT income, less the exemption amount, is multiplied by 20 percent, and the product is reduced by the AMT foreign tax credit, to produce the taxpayer's "tentative minimum tax." The excess of the tentative minimum tax over the taxpayer's regular income tax liability is the taxpayer's AMT liability. This amount must be paid in addition to the taxpayer's regular income tax liability. New Code Sections 55(a), 55(b).

Note: Technically, it is the excess of the taxpayer's tentative minimum tax over its regular income tax that constitutes the taxpayer's AMT liability. In operation, however, the AMT is a true alternative tax system.

D. New Code Structure. In addition to making major substantive changes in the law, the Act restructures and renumbers the code sections dealing with the AMT. New Code Section 55 imposes the AMT. New Section 56 specifies the items that must be recomputed to produce AMT income. New Section 57 defines items of tax preference. New Section 58, which affects primarily individuals, prohibits certain “tax shelter” deductions from being used to reduce AMT income. New Section 59 contains various definitions and special rules.

III. Computation of AMT Income. AXT income is compute? by making various adjustments to regular taxable income, as set forth below.

A. Recovery of Capital Costs.

1. Depreciation.

(a) Personal property. For tangible personal property placed in service after 1986, depreciation deductions allowable in computing AMT income are computed using a 150 percent declining balance method, switching to straight-line depreciation in the year when straight-line depreciation exceeds 150 percent declining balance depreciation. The recovery period is the class life of the property being depreciated. In contrast, for regular income tax purposes, depreciation is computed using a 200 percent declining balance method, over a recovery period that is generally shorter than the class life of the property. New Code Section 56(a)(1) .

(b) Pre-Act personal property. The requirement that depreciation be recomputed for AMT purposes does not apply to pre-Act personal property,

that is, either personal property placed in service before 1987, or personal property that, under the transition rules contained in the Act for regular income tax depreciation, is depreciated under prior lax. For corporations other than personal holdin9 companies, pre-Act personal property is depreciated identically for regular tax and AMT purposes. For personal holding companies, a less generous depreciation allowance for leased pre-Act personal property must be computed, using the straight-line method over a recovery period longer than the regular income tax recovery period. The excess of the depreciation allowed for regular income tax purposes over the less generous allowance constitutes an item of tax preference, which must be added to regular taxable income. New Code Section 57(a)(7).

(c) Real property. For real property placed in service after 1986, AMT depreciation must be computed using the straight-line method over forty years. In contrast, for regular income tax purposes, real property is depreciated on a straight-line basis over 31 1/2 years f c r commercial property and 27 1/2 years for residential property. For real property placed in service before 1987, or real property that is depreciated under prior law pursuant to the transition rules contained in the Act, the excess of accelerated depreciation over straight-line depreciation, using the same recovery period, constitutes an item of tax preference. New Code Sections 56(a)(1), 57(a)(7).

Observation: The treatment of depreciation on property placed in service after 1986 under the Act differs from the treatment of depreciation under the current individual ANT in several ways. First, the Act requires that depreciation on all assets be recomputed, thus permitting taxpayers to offset depreciation deductions in excess of the AMT depreciation allowances with deductions from other assets (in the later years of their useful lives) below the AMT allowances. Second, the Act requires that depreciation deductions be recomputed for all assets, rather than, as under current law, for real property and leased personal property only. Third, because depreciation must be recomputed, whereas the current individual ANT simply treats some depreciation deductions as items of tax preference, every asset will have a different basis for AMT and regular income tax purposes. The ramifications of this provision are discussed infra Section VII.B.

2. Mineral Provisions. The Act extends to corporations the provisions of the current individual AMT restricting the availability of certain deductions relating to natural resources, which are allowable under the regular income tax. Mining development and exploration costs that may be deducted for regular income tax purposes must be capitalized and amortized ratably over ten years in computing AMT income. Percentage depletion constitutes an item of tax preference to the extent that it exceeds the basis of the property for which the depletion deduction is allowed. In addition, intangible drilling costs give rise to an item of tax preference. The amount of the preference is equal to the deduction permitted for intangible drilling costs under the regular income tax, reduce6 first by the amount that would have beer deductible If such costs were amortized over ten years, and further reduced by 65 percent of the taxpayer's net income from oil, gas, and geothermal properties. New Code Sections 56(a)(2), 57(a)(1), 57(a)(2).

B. Accounting Methods.

1. Installment Sales. In computing AMT income, a corporation may not use the installment method of accounting for sales of inventory, or for sales of non-inventory real property where the sales price exceeds $150,000. For practical purposes, this provision applies in taxable years beginning after 1986. Although the AMT installment sales provisions generally apply to sales after February 28, 1986, the new corporate AMT applies only to taxable years beginning after 1986. Therefore, gain. On installment sales made between February 28, 1986 and the end of the first taxable year ending on or after December 31, 1986 is never included in AMT income. Gain on installment sales made on or before February 28, 1986 is included in AMT income to the same extent that it is included in regular taxable income. New Code Section 56(a)(6); see also S. Rep. No. 313, 99th Cong., 2d Sess. 526 n.8 (1986).

Observation: Corporations that expect to be subject to AMT in the coming years can reduce their tax-liability by making installment sales in this year. This technique will require attention to the new regular tax rules governing installment sales, however.

2. Completed Contract Method. The completed contract method of accounting may not be used in computing AMT income, and a taxpayer that uses this method must recompute its income using the percentage of completion method. This provision applies to income from contracts entered into after March 1, 1986, but only for purposes of computing AMT income in years beginning after 1986. New Code Section 56(a)(3).

3. Bad Debt Reserve. For banks, the amount by which the deduction allowed as a reserve for bad debts exceeds the amount that would have been allowed if the deduction had been computed on the basis of actual experience constitutes an item of tax preference. New Code Section 57(a)(4).

C. Tax-Exempt Interest. Interest on private activity bonds, which is exempt from regular income tax, constitutes an item of tax preference, and is thus included in AMT income. A private activity bond, generally, is a bond issued by a state or municipality, if more than ten percent of the proceeds from issuing the bond are used by a private business, and if either the principal of, or the interest on, more than ten percent of those proceeds are either secured by property used in a private business activity, or are to be repaid with revenue derived from a private business activity. State and municipal bonds are also private activity bonds if more than five percent of the proceeds of the bond issuance are used to make loans to non-governmental persons. New Code Section 57(a)(5).

Interest on certain private activity bonds does not constitute an item of tax preference. Generally, interest on bonds issued before August 8, 1986 is not an item of tax preference. Interest on bonds issued to finance activities of tax-exempt charitable organizations also generally is not an item of tax preference. In addition, interest on state and municipal bonds that are not private activity bonds

is not an item of tax preference. New Code Section 57(a)(5)(C).

Observation: In effect, the Act creates two categories of tax-exempt bonds: those that are exempt from both regular income tax and AMT, and those that are exempt from regular income tax, but subject to AMT. It is likely that bonds in the second category will pay higher interest rates than those in the first category. For taxpayers who can predict with some assurance that they will not be subject to the AMT, bonds in the second category may well be a better investment than bonds in the first category.

In computing AMT income, the taxpayer is allowed to deduct interest on indebtedness incurred to purchase bonds the interest on which is an item of tax preference. No such deduction would be allowed for regular tax purposes. The amount of the deduction cannot exceed the amount of the interest income that constitutes an item of tax preference. New Code Section 57(a)(5)(A).

D. Charitable Contributions of Appreciated Property. For regular tax purposes, a taxpayer that contributes long-term capital gain property to charity may deduct the fair market value of the property, without recognizing any gain inherent in the property. For AMT purposes, the Act provides that the excess of the fair market value of the property over its adjusted basis constitutes an item of tax preference. New Code Section 57(a)(6).

E. Passive Losses. Under the Act, severe limitations are imposed, for regular income tax purposes, on the deductibility of passive losses. The applicability of the new passive loss limitations to C corporations is very limited, however. The limitations do not apply at all to corporations that are not closely-held. For these purposes, a corporation is closely-held if more than 50 percent of its stock is owned, directly or indirectly, by five or fewer individuals. Closely-held corporations may deduct passive losses against active business income, but not against portfolio income, such as interest or dividends. Passive losses are generally defined as losses from a trade or business in which the taxpayer does not materially participate, or losses from any rental activity, in excess of income from such activities.

In general, the sane rules regarding deductibility of passive losses apply for AMT purposes as for regular income tax purposes. The only significant difference between the regular tax and the AMT is that the passive loss limitations are phased in for regular income tax purposes, but are applied in full for AMT purposes, beginning in 1967. New Code Section 58(b).

III. Book Income Adjustment.

A. Purpose. The book income adjustment was apparently designed to reduce the perceived embarrassment to the tax system that occurs when large corporations report positive earnings to the public, but pay little or no tax. The book income adjustment provisions apply to all corporations, however, regardless of their size and regardless of whether their earnings are publicly reported.

B. Computation.

1. Place of Book Income Adjustment in AMT Income Computation. AMT income is computed as follows:

(a) First, make all the adjustments previously discussed. The result is hereinafter termed "preliminary AMT income."

(b) Second, make the book income adjustment.

(c) Third, take any allowable NOL deduction, as discussed in Section V infra. New Code Section 56(f)(l).

2. Computation of Book Income Adjustment. The amount of the book income adjustment in computed as follows:

(a) Determine the corporation's "applicable financial statement."

(b) Make the required adjustments to net income as reported on the applicable financial statement.

(c) The result is "adjusted net book income."

(d) Determine the excess (if any) of adjusted net book income over preliminary AMT income.

(e) One-half of this excess constitutes the "book income adjustment" and must be added to preliminary AMT income.

(f) Note that the book income adjustment can never be negative. New Code Sections 56(f)(1), 56(f)(2).

C. Determination of Applicable Financial Statement.

1. General Priority Rules. The applicable financial statement is, in order of preference:

(a) a financial statement required to be filed with the Securities and Exchange Commission;

(b) a certified financial statement used (i) for credit purposes, (ii) for reporting to shareholders, or (iii) for any other-substantial non-tax purpose;

(c) a financial statement required to be provided to (i) the federal government or an agency thereof, (ii) a state government or an agency thereof, or (iii) a local government or an agency thereof; or

(d) an unaudited financial statement used (i) for credit purposes, (ii) for reporting to shareholders, or (iii) for any other

substantial nontax purpose. New Code Section 56(f)(3).

2. Earnings and Profits. If the taxpayer has no applicable financial statement, its current earnings and profits (without reduction for distributions to shareholders) is considered to be its net book income. New Code Section 56(f)(3)(B).

3. Second in Time is Stronger in Right. If the taxpayer has two financial statements of equal priority, the later one is the applicable financial statement. However, an earlier statement of higher priority governs over a later statement of lower priority. S. Rep. No. 313, supra Section III.B.1, at 532.

D. Adjustments to Book Income. Net income (or loss) as reported on the taxpayer's applicable financial statement must be adjusted in several ways.

1. Taxes. Financial statement income must be adjusted so as to disregard any federal income taxes, or any foreign income taxes for which a foreign tax credit is claimed. New Code Section 56(f)(2)(B).

2. Treatment of Affiliated Corporations. Several different types of adjustments may be necessary to reflect differences in the consolidation, for book and tax purposes, of affiliated corporations.

(a) Corporations consolidated for book but not for tax purposes. For book purposes, a corporation may include the income of a foreign subsidiary, or its share of the income of a domestic subsidiary in which it owns less than 80 (but more than 20) percent of the stock. A parent corporation generally may not include such subsidiaries in a consolidated tax return.

In these circumstances, the book income of each member of the group will be that member's net income, which will take into account any intercorporate transactions eliminated in the consolidated financial statement. Thus, a parent corporation will

also include in its adjusted net book income the dividends received (or deemed to be received under other provisions of the Code) from a subsidiary.

(b) Corporations consolidated for tax but not for book purposes. Affiliated corporations that file a consolidated tax return may on occasion issue separate financial statements. In these circumstances, the adjusted net book income of the group will equal the sum of the amounts of net book income reported on the separate financial statements, reduced by any intercorporate dividends reported on those statements. New Code Section 56(f)(2)(C); S. Rep. No. 313, supra Section III.B.1, at 532-33.

3. Statements Covering Different Years. When a corporation uses a different year for accounting and for tax purposes, its adjusted net book income, for AMT purposes, will include pro rata shares of its book income for the years overlapping its taxable year. Thus, for example, a corporation with a calendar taxable year, and a June 30 financial reporting year, would include in its 1988 adjusted net book income one-half the income from its financial year ending on June 30, 1988, and one-half the income from its financial year ending June 30, 1989. New Code Section 56(f)(2)(D); S. Rep. No. 313, supra Section III.B.1, at 533-34.

4. Extraordinary Items. Extraordinary items are included in adjusted net book income, unless they are items of federal or foreign income tax benefit or expense. S. Rep. No. 313, supra Section III.B.1, at 534.

E. Anti-Avoidance Provisions. The Code and the committee reports attempt to anticipate and forestall several avoidance techniques.

1. Issuance of Amended Financial Statements. As mentioned previously, see supra Section IV.C.3, if a corporation issues an amended financial statement, the amended financial statement supersedes the earlier one. This rule applies only if the two statements are in the same priority class, however, that is, an amended

report to shareholders would not supersede an earlier report to the Securities and Exchange Commission. S. Rep. No. 313, supra Section III.B.1, at 532.

2. Issuance of Supplementary Statements. The Senate Finance Committee Report states that the issuance of supplementary statements is to be treated as an amendment and reissuance of the statement to which the supplement relates. S. Rep. No. 373, supra Section III.B.1, at 532. In addition, the conference committee report states that the Internal Revenue Service may "require that adjustments be made to book income where the principles of [the book income] provision would otherwise be avoided through the disclosure of financial information through footnotes and other supplementary statements." 2 H.R. Rep. No. 841, 99th Cong., 2d Sess. at 11-274 (1986).

   It is unclear how broadly these statements apply. For example, if a corporation issues a financial statement using one depreciation method, or one set of assumptions about pension liability, and indicates in a footnote what its income woul6 be using different methods or assumptions, then it is unclear which number is the corporation's book income. It is also unclear whether such things as oral statements at shareholders' meeting, or press releases, qualify as supplementary statements.

3. Posting of Items Directly to Balance Sheet Accounts. Taxpayers may not avoid the book income provision by posting items directly to balance sheet accounts, even (apparently) when such direct posting in the preferred financial accounting method. S. Rep. No. 313, supra Section III.9.1, at 534.

4. General Grant of Regulatory Authority. In addition to the foregoing, the Treasury Department is authorized to issue regulations to prevent the omission or duplication of any item. New Code Section 56(f)(2)(H).

F. Reasons for Divergence Between Book Income and Preliminary AMT Income.

1. Exemption Provisions. Certain items of income exempt from tax are included in book income. Interest on tax-exempt bonds (other than private activity bonds) is not included in preliminary AYT income, but is included in book income. Dividends, which are reduced by the dividends received deductions in computing preliminary AMT income, are fully included in book income.

   Observation: The effect of the book income adjustment is to impose an AMT on tax-exempt interest at a 10 percent rate (20 percent tax rate times 59 percent book income inclusion), and to impose an AMT on dividends at a 12 percent rate (20 percent times the sum of 20 percent plus 50 percent of 60 percent).

2. Timing Provisions. Generally accepted accounting principles and the tax law require (or permit) many items to be reported at different times. For example, depreciation deductions for pre-Act real property, and for all personal property, are generally more accelerated for AMT purposes than for book purposes. In these circumstances, the book income adjustment has the presumably intended effect of reducing the benefit, for some corporations, of generous tax preferences. In other circumstances, however, the book income adjustment penalizes taxpayers for non-abusive transactions that do not involve the use of tax preferences. For example, charges against earnings for unfunded or contingent liabilities, writedowns of inventory, and many other such items reduce book income, but do not reduce preliminary AMT income. In a later year, when previously estimated liabilities are paid, or marked-down inventory is sold, book income may exceed preliminary AMT income, and a tax will be levied equal to ten percent of the excess.

3. Nonrecognition Provisions. Many gains that are not recognized for tax purposes are recognized in computing book income. Examples include gain from involuntary conversions, or gain from Section 337 sales. (Although the Act generally repeals Section 337, certain small corporations may liquidate tax-free until 1989, and there are

some grandfather provisions.) Interestingly, a distribution governed by Section 336 probably does not produce book income.

Ultimately, most nonrecognition provisions (with the exception of Sections 336 and 337) merely defer gain recognition, and therefore affect primarily the timing of tax liability. However, because the book income adjustment can never be negative, a nonrecognition event, such as an involuntary conversion, may produce book income and tax liability in one year, with no offsetting tax benefit in a later year.

G. Substitution of Adjusted Current Earnings for Book Income Adjustment. Beginning in 1990, new Code Section 56(g) provides that an adjustment based on "adjusted current earnings" shall be substituted for the book income adjustment.

1. General Nature of Adjusted Current Earnings. Adjusted current earnings is an amalgam of ANT income, book income, and earnings and profits, as that concept is used in Subchapter C. Although in general adjusted current earnings will be similar to current earnings and profits, adjusted current earnings are in some instances tied to book income. Thus it is not completely accurate to say that earnings and profits is substituted for book income in computing ANT liability after 1989.

2. Computation of Adjusted Current Earnings. Adjusted; current earnings are computed by starting with preliminary AMT income itself, and making the following adjustments:

(a) Depreciation. In computing adjusted current earnings, a corporation recomputes depreciation allowances by using the less generous of: (i) the depreciation method set forth below; or (ii) the depreciation method used for bock purposes. The less generous method means the method with the lower present value determined using a discount rate that apparently will be equal to the applicable federal rate (under Code Section 1274) for a term equal to the useful life of the property. See H.R. Rep. No. 841, supra Section IV.E.2, at II-276.

The depreciation methods that are to be compared to book depreciation are as follows:

(i) for property placed in service after 1989, straight-line depreciation over the class life of the property;

(ii) for property placed in service after 1985 and before 1990, straight-line depreciation, computed over the class life of the property remaining after 1989, using as a depreciable basis the AMT basis of the property at the end of 1989;

(iii) for ACRS property placed in service before 1987, or transition property, straight line depreciation, computed over the class life of the property remaining after 1989, using as a depreciable basis the regular income tax basis of the property at the end of 1989; and

(iv) for pre-ACRS property, the regular income tax depreciation. New Code Section 56(g)(4)(A).

(b) Earnings and Profits. Except for the computation of depreciation, the computation of adjusted current earnings generally follows that of earnings and profits. Thus, in computing adjusted current earnings:

(i) Any item included in earnings and profits (but not in preliminary AMT income) must be included in adjusted current earnings. New Code Section 56(g)(4)(B).

(ii) Any item not deductible in computing earnings and profits (but deductible in computing preliminary AMT income) may not be deducted in computing adjusted current earnings. New code section- 56 (g)(4)(C).

(iii) Certain items must be recomputed in accordance with the rules for

computing earnings and profits. Thus, construction period carrying charges must be capitalized; intangible drilling costs must be capitalized and amortized over five years; mineral exploration costs must be capitalized and amortized over ten years; circulation expenses may not be deducted or amortized; corporate organizational expenses may not be amortized; the LIFO method of inventory valuation generally may not be used; and the installment method of accounting may not be used. New Code Section 56(g)(4)(D).

(c) Special Rules.

(i) Mineral provisions. If the taxpayer uses a less favorable method for book purposes than for earnings and profits purposes of computing deductions attributable to intangible drilling costs or mineral exploration costs, the taxpayer must use that less favorable method in computing adjusted current earnings. The taxpayer must compute depletion allowances under either the cost depletion method or the method used for book purposes, whichever is less favorable. New Code Sections 56(g)(4)(D)(ii),56(g)(4)(G).

(ii) Exchanges of debt pools. In computing adjusted current earnings, no loss is allowed on an exchange of debt instruments for other instruments of similar effective interest rates and maturities. New Code Section 56(g)(4)(E)

3. Computation of Adjustment for Adjusted Current Earnings. Once it has computed its adjusted current earnings, a corporation adjusts its preliminary ANT income as follows:

(a) If adjusted current earnings exceed preliminary ANT income, AMT income is increased by 75 percent of the excess. New Code Section 56(g)(1)

(b) If adjusted current earnings are less than preliminary AYT income, AMT income is decreased by 75 percent of the difference. However, the amount of the allowable decrease in limited to the amount of the net increase in all prior years arising from the adjusted current earnings provision. New Code Section 56(g)(2).

Example: In the years 1990 through 1992, a corporation has preliminary AMT income of $3 million in each year. Its adjusted current earnings are $4 million in 1990, $2.5 million in 1991, and $2 million 1992. In 1990, the corporation will increase its preliminary AXT income by $750,000, which is 75 percent of the excess of adjusted current earnings over preliminary AMT income. In 1991, the corporation will decrease its preliminary AMT income by $375,000, which is 75 percent of the excess of preliminary AMT income over adjusted current earnings. In 1992, 75 percent of the excess of preliminary AMT income over adjusted current earnings would be $750,000, but the corporation may only decrease its preliminary AMT income by $375,000, the amount of the net increase in prior years.

There is no carryover of disallowed decreases in preliminary AMT income. Thus, the corporation in the preceding example will never receive any benefit from the unused excess of its 1992 preliminary AMT income ever its 1992 adjusted current earnings.

V. Net Operating Losses

A. Allowance of Net Operating Loss Deduction. A net operating loss (“NOL”) deduction may be taken against AMT income. For AMT purposes, however, an NOL deduction may offset only 90 percent of AMT income. New Code Section 56(d)(1)(A).

In computing AMT income, the taxpayer must first make all the required computations other than the book income adjustment and the computation of its NOL deduction. Next, the taxpayer adds the book income adjustment, and then subtracts

its allowable NOL deduction. Thus, NOLs may offset book income. New Code Section 56(f)(1)(B).

B. Computation of NOL Deduction. Regular tax NOLs arising in years after 1986 must be recomputed, in accordance with the rules for computing AMT income, in order to determine the amount available as a carryover for AMT purposes. Thus, for example, if a corporation has regular taxable income of minus $100 in 1987, and ANT income in that year of minus $50, it could carry over $100 as an NOL deduction for regular tax purposes, but it could carry over only $50 as an NOL deduction for AYT purposes. New Code Section 56(d)(2)(A).

Regular tax NOLs from years prior to 1987 may generally be carried forward in full for AMT purposes (and applied against up to 90 percent of AMT income), with one major exception. Under current law, a corporation need not pay the 15 percent add-on minimum tax in any year in which it has an NOL. The tax is deferred until the carryover NOL attributable to the untaxed items of tax preference is used. Under the Act, if tax has been deferred in this matter, the corporation's NOL carryover available for AMT purposes is reduced by the total amount of the items of tax preference on which add-on tax was deferred. New Code Section 56(d)(2)(B); Act Section 701(f)(2)(B).

A taxpayer's AMT NOL carryover is reduced only by the allowable NOL deduction. For example, a taxpayer that has AMT income of $100,000 could take an NOL deduction of only $90,000. If the taxpayer had, at the beginning of the year, an AMT NOL carryover of $200,000, the available carryover at the end of the year would be $110,000. New Code Section 56(d)(1)(B).

VI. Tax Credits. As a general rule, the only tax credit that may be used to offset AMT liability is the AMT foreign tax - credit. A transition rule, provides, however, tax credits ("ITCs") may be used to partially that investment offset AMT liability.

A. Foreign Tax Credit. In general, the AMT foreign tax credit is computed in the same fashion as the regular foreign tax credit, except that AMT income is substituted for regular taxable income, and an amount equal to 20 percent of the excess of AMT income over the exemption amount is substituted for regular income tax liability. In making this computation, any amount of AMT income attributable to the book income adjustment is treated as having the same proportionate source and character as ANT income computed without regard to the book income adjustment. It is unclear what happens if AMT income computed without regard to the book income adjustment is negative. AMT income attributable to the adjusted current earnings adjustment is sourced on an item-by-item basis. New Code Section 59(a)(1); 2 H.R. Rep. No. 841, supra Section IV.E.2, at II-282 (1980).

B. ITC. The Act provides that ITCs may be used to offset up to 25 percent of a taxpayer's tentative minimum tax liability. (Although the Act generally repeals the ITC, ITCs are available for transition property, and many corporations will have carryover ITCs from prior years.) New Code Section 38(c)(3).

C. Limitation on Credits. The combination of AMT NOLs, AYT foreign tax credits and ITCs may not completely eliminate a taxpayer's AMT liability. As noted previously, the AMT NOL deduction may not exceed 90 percent of AMT income determined without regard to the NOL deduction. Furthermore, AMT NOLs, AMT foreign tax credits, and ITCs may not reduce the taxpayer's tentative minimum tax (determined without regard to AMT NOLs or the AMT foreign tax credit) below 90 percent of what it would otherwise be. If the taxpayer has used an NOL deduction to offset a full 90 percent of its AMT income, therefore, no AMT foreign tax credit or ITC will be allowed. New Code Sections 38(c)(3), 59(a)(2).

VII. Interactions and Adjustments Between Different Years

A. Two Track System. In effect, the Act creates two parallel tax systems, the AMT and the regular income tax. In each year, a taxpayer will compute both its AMT income and its regular taxable income, and pay, in essence, either 20 percent of its AMT income, or 34 percent of its regular taxable income. In addition, various tax attributes that carry over from year to year, such as NOLs, are computed differently under the AMT and the regular tax, and the different amounts are both carried forward.

The Act creates several mechanisms whereby adjustments are made to reflect the fact that a taxpayer may be subject to the AMT in some years, and to the regular income tax in other years.

B. Basis. As noted previously, see supra Section III.A.1, assets will generally have different bases for AYT an6 regular tax purposes. The adjusted basis, for AMT purposes, of property for which depreciation is recomputed under the AMT will reflect the AMT deductions. Hence, gain on the disposition of such property will generally be lower for AMT than for regular tax purposes. In addition, the basis, for AMT purposes, of any mine or mineral deposit will reflect the fact that certain expenditures were capitalized in computing AMT income. New Code Section 56(a)(7).

C. AMT Credit. The Act also provides that AMT paid with respect to any year after 1986 is allowed as a credit against regular tax liability in subsequent years, to the extent that the AMT liability in the prior year was the result of "deferral preferences," but not to the extent that AMT liability was attributable to "exemption preferences." This credit is allowed regardless of whether the regular tax liability in the later years is connected with the items that produced AMT liability in the earlier years. The credit may not reduce regular income tax below the tentative minimum tax, however.

"Deferral preferences" are preferences, such as accelerated depreciation, that merely shift

income from, one year to another. In contrast, "exemption preferences," such as the exclusion from income, for regular income tax purposes, of interest on private activity bonds, allow items of income to escape taxation permanently. For these purposes, the entire amount of the AMT attributable to the book income adjustment is classified as attributable to a deferral preference. Any AMT liability attributable to the adjusted current earnings adjustment is evaluated on an item-by-item basis to determine whether it is attributable to exemption preferences or deferral preferences. New Code Section 53.

Note: Recall that, technically, the taxpayer's AMT liability is the excess of its tentative minimum tax over its regular income tax. A taxpayer who is subject to the AMT pays its regular income tax liability plus this excess. It is this excess amount that is available as a credit.

Example 1: In year 1, a taxpayer has both regular taxable income and AMT income of $2 million before depreciation. Its regular income tax depreciation is $1.6 million, and its AMT depreciation is $1.2 million. Assume that there are no other adjustments (such as the book income adjustment) to be made in computing AMT income. The taxpayer will have regular taxable income of $400,000, and AMT income of $800,000. The taxpayer's regular income tax liability will be $136,000, its tentative minimum tax liability will be $160,000, and its AMT liability will therefore be $24,000. If, in year 2, the taxpayer has both regular taxable income and AXT income of $1 million, its regular income tax liability will be $340,000, and its tentative minimum tax liability will be $200,000. The taxpayer will be entitled to a credit of $24,000 against its regular income tax, reducing its tax liability to $316,000. This result applies regardless of whether the taxpayer in year 2 sells the property that it depreciated in year 1, or keeps the property and continues to depreciate it.

Example 2: In year 1, a taxpayer has regular taxable income of $400,000 and earns interest on private activity bonds of $400,000. If there are

no other adjustments to be made in computing AMT income, the taxpayer will have AMT income of $800,000. Its regular income tax liability will be $136,000, its tentative minimum tax liability will be $160,000, and its ANT liability will therefore be $24,000. If, in year 2, the taxpayer has both regular taxable income and AMT income of $1 million, it will pay regular income tax of $340,000 and no credit will be available, because the AMY liability in year 1 was attributable to exemption preferences.

Observation: The corporation in Example 1 pays a total tax, in both year 1 and year 2, of $476,000, which is 34 percent of its total regular taxable income of $1.4 million. The AMT merely accelerates a portion of this liability. The taxpayer in Example 2, in contrast, pays more than 34 percent of its total regular taxable income.