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Tax Symposium: Introduction

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INTRODUCTION

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The Tax Reform Act of 1986 (TRA'86) was the result of remarkably powerful public pressure for revision of the Internal Revenue Code (the "Code"). Congress optimistically labeled the measure tax simplification, although sceptics refer to the new law as tax complification. While there is some merit to the sceptics' criticisms, it is important that we not lose sight of the change of direction that the TRA'86 accomplished and the fairer tax era that the new law ushered in.

Under the new law, millions of individual taxpayers will benefit from lower rates, from increased standard deductions and personal exemptions, and from modification of confusing tax provisions. The number of persons who will need to itemize deductions has been reduced to about twenty percent of all those who file tax returns. The tax obligations of six million taxpayers have been eliminated altogether. In all, about fifty-eight percent of the people will pay less tax; twenty-six percent will pay about the same as they do now; and fifteen percent will pay more. For most taxpayers, therefore, the new law will offer significant relief from the burdens of complying with the tax laws.

The TRA'86 reflects the chief objective of its framers — that taxpayers with similar incomes should pay essentially the same amount of tax. This injects an element of fairness into the system that was absent in prior tax laws. At the same time the new law reflects a departure from the recent trend toward attempting to cure a wide variety of social and economic problems through tax incentives and tax subsidies. While tax incentives offered ways for Americans to lower their taxable incomes, and thus their tax liabilities, they also created a tax code riddled with preferences which benefited a host of special-interest groups. These preferences had been initiated with the best of intentions, but they produced a tax code that was extraordinarily complex. Even more important, they had the singular effect of reducing the tax base, thus shifting the burden of providing needed federal revenue to an ever-narrowing constituency. Furthermore, the advantages taxpayers secured through these tax preferences gradually became a powerful incentive to base investment decisions primarily on tax consequences rather than on economic consequences.

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This in turn created distortions in the investment decision-making process while fostering a perception of unfairness in the system.

The elimination of these tax preferences will undoubtedly increase taxes for certain wealthier individuals and businesses. Furthermore, change in and of itself will increase complexity. But it is fair to say that the revised Code chiefly burdens those with the financial wherewithal to afford both the higher taxes and the cost of dealing with complexity. It remains to be seen whether the new law will eliminate distortions from the investment decision-making process, and whether it will persuade taxpayers that the Code is now more equitable and less conducive to abuse than was its predecessor, and thus foster the voluntary compliance upon which our tax system depends.

This symposium focuses on some specific provisions of the TRA'86 which attempt to remedy inequities or reduce complexity in the prior Code. The authors discuss the impact of these new provisions and comment on the issues which remain unresolved despite reform.

The foreign tax provisions of the Code have been the stimulus for extraordinary taxpayer ingenuity and consequently a frequent focus of congressional attention. In the lead article, Walter Schwidetzky reviews and analyzes the modifications in the TRA'86 to subpart F, which deals with the taxation of Controlled Foreign Corporations. While he finds that the new law is a substantial improvement over the old, the author asserts that a more comprehensive system of taxation is needed in this area. Had the TRA'86 adopted a more inclusive system of taxation he argues, Congress would have better served its revenue and policy goals while meeting the taxpayers' need for comprehensible tax provisions and reliable guidance in their administration.

Although the general tendency of the TRA'86 was toward the reduction or elimination of tax credits, a new credit was introduced in order to address the growing concern that additional subsidies were needed in order to stimulate development of housing for low to moderate income individuals. Andrew Z. Blatter and Elena Marty-Nelson examine the operation of the Low Income Housing Tax Credit, focusing on the practical considerations and problems which taxpayers hoping to use the credit must address.

Lynn Wintriss and A. M. Plant write about the major revision of the Chapter 13 generation skipping transfer tax brought about by the TRA'86. The complexity of this tax had made it a prime target for repeal or reform ever since it was enacted in 1976. The new law promises to be more effective and even-handed than its predecessor, but it nevertheless remains one of the more complex sections of the estate and gift tax code. The authors believe that the revised generation skipping tax is here to stay and attempt to provide practitioners with a workable understanding of its provisions.

Simplification and fairness were the objectives of the amendments to Code sections 311, 336, and 337 which were enacted by the TRA'86.

These amendments effectively repealed the fifty-three year old *General Utilities* doctrine, under which no gain recognition was required at the corporate level upon distribution of appreciated corporate assets. This doctrine created inordinate complexity in subchapter C of the Code and was riddled with exceptions designed to prevent abuse. J. Ronald Shiff argues that by requiring subjective judgments as to whether a transaction is to be taxed, and by delegating broad regulatory authority to the Treasury Department, the TRA'86 has merely replaced the old set of problems with new complexities and uncertainties which may have a dampening effect on business development.

The abuse of "loss trafficking," whereby one corporation acquires the stock of another in order to exploit the second corporation's net operating loss carryover, first became a focus of congressional concern in the Revenue Act of 1943. The TRA'86 retained the anti-trafficking provisions enacted in 1943, but made major changes in Code section 382, which had been enacted in 1954 to eliminate the subjective "principal purpose" standard by which a corporate acquisition was tested under the 1943 Act. The new section 382 significantly limits the earnings against which a net operating loss carryforward can be applied when a substantial ownership change occurs, whether through a taxable acquisition or a tax-free reorganization. William M. Davidow, Jr. examines the most important provisions of the new section 382 and discusses the impact of the changes on the availability of the net operating loss carryover deduction in the future.

Abusive tax shelters, particularly real estate limited partnerships, were one of the prime targets of the TRA'86. Under new Code section 465 the at-risk rules applicable to other limited partnerships have been extended to real estate, but the impact of the change has been softened by the provision that a taxpayer is deemed to be at risk for his share of any "qualified nonrecourse financing" secured by the real property used in the investment activity. Olivia S. Byrne reviews the development of the at-risk rules and examines in detail the qualified nonrecourse financing exception. She then discusses several issues which tax planners must consider while they await the new regulations and suggests techniques for formulating an investment strategy.

The intent of Congress to attack abusive tax shelters in the TRA'86 is especially evident in new Code section 469, which prevents taxpayers from sheltering active business income, salaries, and portfolio income with passive losses from activities not related to the taxpayer's trade or business, and which further limits credits from passive activities to the tax attributable to those activities. Lester D. Bailey reviews the changes which the TRA'86 and the Omnibus Budget Reconciliation Act of 1987 brought about and the likelihood of future regulation in this area. He observes that while Code section 469 appears to be the ultimate weapon in the tax shelter war, it threatens to create accounting and legal problems which may lead to haphazard compliance and vitiate the section's effectiveness as an anti-shelter measure.

The symposium concludes with an article by Fred W. Peel, Jr., who finds that although the TRA'86 improved horizontal tax equity by taxing capital gains at the same rates as other income, its failure to apply horizontal equity principles to net capital losses leaves both residual complexity and unfair burdens in the Code which are not justified by policy considerations. He suggests that the source of the problem lies in Congress's concern about the revenue loss that might occur if taxpayers were permitted to engage in "cherry picking," — that is, realizing losses on unsuccessful investments while retaining the successful ones until death, when they are given a stepped-up in basis. He argues that if death were treated as a realization event (except as to transfers between spouses), the illogical and unfair treatment of net capital losses throughout the Code could be corrected.

As Director of the Graduate Tax Program of the University of Baltimore, I am especially pleased that the *Law Review* has devoted an issue of its seventeenth volume to a symposium on the Tax Reform Act of 1986. Both the symposium and the Graduate Tax Program at the University of Baltimore School of Law are timely efforts to aid Maryland practitioners in working with the Internal Revenue Code.

The Graduate Tax Program is now in its second year of operation. It was established to meet the needs of local practitioners which were revealed through a 1985 survey conducted by the State of Maryland. In January 1986 the Section of Legal Education and Admissions to the Bar of the American Bar Association adopted the recommendation of its Accreditation Committee to acquiesce in the establishment of an LL.M. in Taxation at the University of Baltimore School of Law. Shortly thereafter, the decision was reached that a joint program, offering the LL.M. in Taxation for lawyers and the M.S. in Taxation for accountants, would best serve the needs of the legal, accounting, and business communities in Maryland. This interdisciplinary program will prepare students for professional tax practice and provide a vital understanding of the complexity in the field of taxation, which has such a critical impact on the legal and accounting professions and on the effective management of business, financial, and government organizations.