

TECHNICAL CORRECTIONS ACT OF 2007 INCLUDES MANY SUBSTANTIVE CHANGES

The "Tax Technical Corrections Act of 2007" (TCA), was passed by Congress on December 19, 2007, and awaits the President's signature. Although many of the TCA's changes are strictly clerical in nature, a number of them make substantive changes to legislation which was enacted in recent years. For example, the TCA:

- liberalizes the rules for claiming the refundable AMT credit (introduced by the Tax Relief and Health Care Act of 2006),
- revises the rules for a shareholder basis reduction on account of contributions of appreciated property by S corporations (introduced by the Pension Protection Act of 2006), and
- revises several important tax rules dealing with the definition of active business income and computing the foreign earned income exclusion (introduced by the Tax Increase Prevention Act of 2005).

Following are highlights of some of the more widely applicable provisions of the TCA. Unless otherwise indicated, all changes are retroactively effective as if included in the legislation which enacted the provision being changed.

■ AMT Refundable Credit Amount Liberalized

Under the Tax Relief and Health Care Act of 2006, for tax years beginning after December 20, 2006, if an individual has a "long-term unused minimum tax credit" for any tax year beginning before January 1, 2013, the amount determined under the Code limit on the minimum tax credit for the tax year can't be less than "the AMT refundable credit" amount for that tax year. The credit is subject to a phase out, and is refundable.

Under pre-TCA law, the "AMT refundable credit amount" is the greater of:

- (1) the lesser of \$5,000 or the long-term unused minimum tax credit; or
- (2) 20% of the long-term unused minimum tax credit.

The long-term unused minimum tax credit (MTC) for any tax year is the portion of the minimum tax credit attributable to the adjusted net minimum tax for tax years before the 3rd taxable year immediately preceding the tax year (assuming the credits are used on a first-in, first-out basis).

A taxpayer whose AGI for a tax year exceeds an annually-adjusted threshold amount must reduce his AMT refundable credit amount by 2% for each \$2,500 (or fraction thereof) by which his AGI exceeds the threshold amount. For example, for 2007, the threshold amount is \$234,600 for married couples filing jointly and surviving spouses

and \$156,400 for singles.

New law. Under the TCA, the AMT refundable credit amount for a year beginning before 2013 (before any reduction by reason of adjusted gross income) is an amount, not in excess of the long-term unused MTC for that year, equal to the greater of:

- (1) \$5,000;
- (2) 20% of the long-term unused minimum tax credit; or
- (3) the AMT refundable credit amount (if any) for the prior tax year - the preceding year's credit amount—before any reduction by reason of adjusted gross income.

Observation: By providing that an individual's AMT refundable credit amount for a tax year is the greatest of items (1), (2) and (3) listed above, the TCA gives the taxpayer an AMT refundable credit amount of at least \$5,000 for a tax year, provided the individual's long-term unused MTC is at least \$5,000.

Illustration: Jack's adjusted gross income for all tax years is less than the threshold amount that triggers a phase out of long-term unused minimum tax credits. He has a long-term unused minimum tax credit for 2007 of \$100,000 and has no other minimum tax credits.

Under pre-TCA law, Jack's AMT refundable credit amount is as follows (for each year, it's equal to 20% of the long-term unused MTC):

- \$20,000 in 2007 ($.20 \times \$100,000$);
- \$16,000 in 2008 ($.20 \times [\$100,000 - \$20,000]$);
- \$12,800 in 2009 ($.20 \times [\$100,000 - \$20,000 - \$16,000]$);
- \$10,240 in 2010 ($.20 \times [\$100,000 - \$20,000 - \$16,000 - \$12,800]$);
- \$8,192 in 2011 ($.20 \times [\$100,000 - \$20,000 - \$16,000 - \$12,800 - \$10,240]$);
and
- \$6,554 in 2012 ($.20 \times [\$100,000 - \$20,000 - \$16,000 - \$12,800 - \$10,240 - 8,192]$)

Under the TCA, Jack's AMT refundable credit amount is:

- for 2007 - \$20,000 ($.20 \times \$100,000$ long-term unused MTC for 2007), because it's more than \$5,000, reducing his long-term unused MTC to \$80,000;
- for 2008 - \$20,000 (2007 AMT refundable credit amount - the preceding year's credit amount), because that amount is more than \$16,000 ($.20 \times \$80,000$) or \$5,000, reducing his long-term unused MTC to \$60,000;

- for 2009 - \$20,000 (the preceding year's credit amount - i.e., the 2007 AMT refundable credit amount), because it's more than \$12,000 ($.20 \times \$60,000$) or \$5,000, reducing his long-term unused MTC to \$40,000;
- for 2010 - \$20,000 (the preceding year's credit amount - i.e., the 2007 credit amount) because that amount is more than \$8,000 ($.20 \times \$40,000$) or \$5,000, reducing his long-term unused MTC to \$20,000;
- for 2011 - \$20,000 (the preceding year's credit amount - i.e., the 2007 credit amount) because that amount is more than \$4,000 ($.20 \times \$20,000$) or \$5,000, reducing his long-term unused MTC to zero.
- for 2012 - zero, because Jack has no long-term unused MTCs for 2012.

Observation: As the illustration shows, the TCA increases the AMT refundable credit amounts individuals may claim in Years 2 through 5 over what they could have claimed under pre-TCA law. The Act also accelerates the exhaustion of the individual's long-term unused MTC.

■ Revised Tax Computation When Foreign Earned Income Exclusion is Utilized

An individual's regular tax liability is calculated by using graduated rates. However, for regular tax purposes, net capital gain is subject to a maximum 15% rate, net capital gain consisting of unrecaptured section 1250 gain is subject to a maximum 25% rate and certain collectibles gain is subject to a maximum 28% rate.

In addition to regular tax, both individuals and corporations are subject to the alternative minimum tax (AMT). The AMT is based on alternative minimum taxable income (AMTI) which generally equals regular taxable income for the tax year increased by certain tax preference items and adjusted to reflect the recomputation of certain other tax items taken in account in computing regular tax. The taxpayer subtracts the exemption amount from the AMTI to get the "taxable excess." The AMT equals the tentative minimum tax less the regular tax for the year.

For individuals and noncorporate taxpayers the tentative minimum tax is 26% of the taxable excess up to \$175,000, plus 28% of the taxable excess above \$175,000 reduced by any AMT foreign tax credit for the year. However, for a noncorporate taxpayer with net capital gain the same rates which apply for regular tax purposes (discussed above) apply for AMT purposes.

Under the Tax Increase Prevention Act of 2005 (TIPRA), for tax years beginning after 2005, where a taxpayer claimed a foreign earned income or foreign housing cost exclusion ("excluded amounts") the regular tax was calculated under a stacking rule. Thus, the regular tax was equal to the excess (if any) of:

- the regular tax which would be imposed for the tax year if the taxpayer's taxable income were increased by the amount of these exclusions for the tax year, over
- the tax which would be imposed for the tax year if the taxpayer's taxable income were equal to the amount of these exclusions for the tax year.

Similarly, his tentative minimum tax for the tax year was equal to the excess (if any) of:

- the amount which would be the tentative minimum tax for the tax year (calculated after reduction for any AMT foreign tax credits) if the taxpayer's taxable excess were increased by the amount of these exclusions for the tax year, over
- the amount which would be the tentative minimum tax for the tax year (calculated after reduction for any AMT foreign tax credits) if the taxpayer's taxable excess were equal to the amount of these exclusions for the tax year.

New law. For tax years beginning after 2006, the TCA amends the regular tax computation and the AMT computation when an individual taxpayer excludes amounts under the foreign earned income or foreign housing cost exclusion.

- **Regular tax computation.** The TCA amends the regular tax computation to provide that, where a taxpayer has excluded amounts and has taxable income for the tax year, the regular tax is equal to the excess (if any) of:

- (1) the regular tax which would be imposed for the tax year if the taxpayer's taxable income were increased by the amount of these exclusions for the tax year; over
- (2) the tax which would be imposed for the tax year if the taxpayer's taxable income were equal to the amount of these exclusions for the tax year.

However, if the taxpayer's net capital gain exceeds his taxable income for a tax year (i.e., there is a "capital gain excess"):

- (1) the taxpayer's net capital gain (determined without including any qualified dividend income in net capital gain) is reduced (but not below zero) by the net capital gain excess;
- (2) the taxpayer's qualified dividend income is reduced by the portion of the capital gain excess which exceeds the taxpayer's net capital gain (determined without including any qualified dividend income in net capital gain) and the reduction under the above item, and
- (3) adjusted net capital gain, unrecaptured section 1250 gain and 28% rate gain are each determined after increasing the amount which is treated as capital loss for purposes of calculating 28% rate gain and unrecaptured section 1250 gain by the capital gain excess. Thus, it is treated as a long-term capital loss carried to the tax year.

Illustration: In 2007, an unmarried individual has \$80,000 of excluded income, a \$30,000 gain from the sale of a capital asset and \$20,000 deductions. The taxpayer's taxable income is \$10,000. The taxpayer's tax is the excess of the amount of tax computed on taxable income of \$90,000 (\$10,000 taxable income plus \$80,000 excluded income) of which \$30,000 is adjusted net capital gain, over the tax computed on the \$80,000. In determining the tax on the \$90,000, the net capital gain and the adjusted net capital gain are each \$10,000. This results in a tax of \$1,500 (15% of \$10,000 of adjusted net capital gain).

Observation: Absent the provision, the tax on the \$90,000 would have been calculated as if \$30,000 were capital gain, while the tax on the \$80,000 would have been calculated at ordinary income rates, with the result that the individual may have escaped tax entirely.

Illustration: In 2007, an unmarried individual has \$90,000 of excluded income, a \$5,000 gain on the sale of a capital asset held for more than a year, \$25,000 unrecaptured section 1250 gain and \$20,000 deductions. The taxpayer's taxable income is \$10,000. The taxpayer's tax is the excess of the amount of tax computed on taxable income of \$100,000 (\$10,000 taxable income plus \$90,000 excluded income) over the amount of tax computed on taxable income of \$90,000 (excluded income). In determining the tax on the \$100,000, the net capital gain is \$10,000, of which \$5,000 is adjusted net capital gain and \$5,000 is unrecaptured section 1250 gain. This results in a tax of \$2,000 (15% of \$5,000 adjusted net capital gain plus 25% of \$5,000 unrecaptured section 1250 gain).

- **Alternative minimum tax computation.** The TCA amends the AMT computation to provide that, where a taxpayer has excluded amounts and has a taxable excess, his tentative minimum tax *before reduction by the AMT foreign tax credit* is equal to the excess (if any) of:
 - (A) the amount which would be the tentative minimum tax (taking into account the special capital gains rates) for the tax year *before reduction by the AMT foreign tax credit* if the taxpayer's taxable excess (generally, the AMTI minus the exemption amount) were increased by the amount of these exclusions for the tax year; over
 - (B) the amount which would be the tentative minimum tax (taking into account the special capital gains rates) for the tax year *before reduction by the AMT foreign tax credit* if the taxpayer's taxable excess were equal to the amount of these exclusions for the tax year.

Thus, in computing the tentative minimum tax on the remaining income, the tax computation is made before the reduction for the AMT foreign tax credit. This conforms the AMT computation to the regular tax computation, which is also made before the application of the foreign tax credit.

Where, without regard to this rule, a taxpayer's net capital gain would exceed his taxable excess for a tax year, the amount in items (A), using the alternative minimum tax capital gains calculation, is determined:

- by applying the regular tax rules described above in items (1), (2) and (3) under the "Regular tax computation," but substituting the taxable excess for taxable income, and
- the reference in the alternative minimum tax capital gains calculation to the net capital gain which is subject to a 5% rate under is to be read as a reference to that amount determined by applying the regular tax rules described in items (1), (2) and (3).

For this purpose, terms in the above rules that are also used in the Code Section

1(h) capital gains rules have the meanings used in the capital gains rules, except that in applying the above rules for minimum tax purposes, the minimum tax rules are taken into account.

■ **Donee Use of Donated Personal Property Must be Substantially Related to its Purpose or Function to Avoid Problems for Donor**

For contributions of “applicable property” where the donee disposes of the property within specified time periods following the contribution, the donor's deduction is subject to reduction (if the disposition occurs in the same year as the contribution) or recapture (if the disposition occurs with specified time periods following the year of the contribution). “Applicable property” is charitable deduction property:

- (A) that is tangible personal property whose use is identified by the donee as related to the purpose or function that is the basis of the donee's exemption, and
- (B) for which a deduction in excess of the donor's basis is allowed.

The reduction and/or recapture consequences can be avoided if the donee provides a certification. This certification consists of a written statement which satisfies one of two sets of requirements. Under pre-TCA law, the written statement under one of these sets of requirements:

- (1) had to be signed under penalty of perjury by an officer of the donee organization;
- (2) had to certify the donee's use of the property was related to the purpose or function that was the basis for its tax-exemption; and
- (3) had to describe how the property was used and how use furthered that purpose or function.

New law. Under the TCA, the written statement satisfies the requirement at (2) above only if, in addition to certifying that its use of the donated property was related to its exempt use or function, the donee organization certifies that its use of the donated property was substantial.

Observation: In other words, the donee must certify not only that its use of the donated property was related to its exempt purpose or function, but also that its use of the property was substantial.

Observation: The TCA doesn't provide a definition of “substantial” for this purpose.

Note the TCA also changes the definition of “applicable property.” It provides that the definition of “applicable property” for purposes of the reduction required in the amount of the taxpayer's deduction if the donee disposes of the property before the end of the contribution year no longer includes the requirement described at (B), above.

■ **Penalty for Substantial and Gross Valuation Misstatements Attributable to**

Incorrect Appraisals

The 2006 Pension Protection Act (PPA) imposed a penalty on any person:

- (A) who prepared a property appraisal and knew, or reasonably should have known, the appraisal would be used in connection with a return or a refund claim, and
- (B) the claimed property value on the return or refund claim that was based on the appraisal resulted in a substantial valuation misstatement under or a gross valuation misstatement for the property.

The penalty equaled the lesser of:

- (1) the greater of: (a) 10% of the underpayment, as defined, attributable to the misstatement described in (B) above, or (b) \$1,000, or
- (2) 125% of the gross income for preparing the appraisal received by the person who prepared it.

Under pre-TCA law, the period of limitations for the assessment of penalties (preparer penalties for understatements of taxpayer liability due to an unreasonable positions) and penalties (certain other preparer penalties) was three years from the date the return or refund claim for which the penalty was assessed, was filed.

New law. The TCA provides that the valuation misstatement penalty described above will also apply to any person who prepares an appraisal upon which a substantial estate or gift tax valuation understatement is based.

Observation: Thus, in addition to persons who are currently subject to the penalty for valuation misstatements attributable to incorrect appraisals, that penalty will also apply to any person who:

- (1) prepares a property appraisal and knows, or reasonably should have known, the appraisal would be used in connection with a return or a refund claim, and
- (2) the claimed property value on the return or refund claim that is based on the appraisal results in a substantial estate or gift tax valuation understatement.

The TCA also provides that the penalty for valuation misstatements attributable to incorrect appraisals is subject to a three-year limitation period.

Observation: Thus, the period of limitations for the assessment of a penalty is three years from the date that the return or refund claim for which the penalty is assessed, is filed.

■ **Retroactive Repeal of Limits on Estate & Gift Tax Charitable Deductions for Series of Fractional Contributions of Tangible Personal Property**

The 2006 Pension Protection Act (PPA) included a rule which provided that, if a taxpayer made a lifetime gift of an undivided portion of his entire interest in any

tangible personal property, for which an income tax charitable deduction was allowed (an “initial fractional contribution”), and then, on his death, the taxpayer made an additional bequest, legacy, devise or transfer of an interest in the same property (an “additional contribution”), there was a limit on the amount of the *estate tax* charitable deduction allowable for the additional contribution. For estate tax charitable deduction purposes, the fair market value of the additional contribution was determined by using the lesser of -

- the fair market value of the property at the time of the initial fractional contribution, or
- the fair market value of the property at the time of the additional contribution.

Observation: Thus, under PPA, any post-gift appreciation in the value of the tangible personal property was not taken into account in determining the amount of the estate tax charitable deduction. If, however, the property declined in value after the date of the lifetime gift, the reduction in value was taken into account for purposes of determining the estate tax charitable deduction.

The PPA also provided a similar rule for *gift tax* charitable deduction purposes. Under this rule, if a donor made a gift of an undivided portion of his entire interest in any tangible personal property, for which a gift tax charitable deduction was allowed (an “initial fractional contribution”), there was a limit on the amount of the gift tax charitable deduction allowable for any later gift of an interest in property with respect to which the donor had previously made an initial fractional contribution (an “additional contribution”). For gift tax charitable contribution purposes, the value of an additional contribution was determined by using the lesser of -

- the fair market value of the property at the time of the initial fractional contribution, or
- the fair market value of the property at the time of the additional contribution.

Observation: Thus, if the tangible personal property appreciated in value after the date of the initial fractional contribution, the appreciation was not taken into account in determining the amount of the gift tax charitable deduction allowed for additional contributions. If, however, the property declined in value after the date of the initial fractional contribution, the reduction in value was taken into account for purposes of determining the gift tax charitable deduction for additional contributions.

The PPA also imposes similar limits on the *income tax* charitable deduction allowable for “additional contributions” of fractional interests in tangible personal property.

Observation: The limits on the income tax charitable deduction for additional contributions of fractional interests in tangible personal property do not result in the kind of “valuation whipsaw” that was caused by the limits on the estate and gift tax charitable deductions.

New law. Congress realized that the limits imposed by the PPA on the estate and gift

tax charitable deductions allowable for “additional contributions” of tangible personal property had unintended consequences (i.e., the valuation whipsaws described above). Thus, the TCA retroactively repeals these rules.

Observation: Thus, the TCA eliminates the valuation whipsaws which would have resulted from the limits imposed by the PPA on the estate and gift tax charitable deductions allowable for “additional contributions” of fractional interests in tangible personal property.

Observation: The TCA does *not* repeal the Code Section which imposes limits on the *income tax* charitable deduction allowable for “additional contributions” of fractional interests in tangible personal property. Those limits do not result in the kind of “valuation whipsaw” which would have been caused by the repealed limits on the estate and gift tax charitable deductions. However, the limits on the income tax charitable deduction still provide a disincentive to making charitable contributions of fractional interests in tangible personal property because, even if the property appreciates in value after the initial fractional contribution, the income tax charitable deduction must nevertheless be based on the value of the property at the time of the initial fractional contribution.

■ **How Special Elective Deferral Limit Applies to Designated Roth Contributions**

Under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), a special rule allows certain employees to make additional elective deferrals to a tax-sheltered 403(b) annuity, subject to (1) an annual limit of \$3,000, and (2) a cumulative limit of \$15,000 minus the amount of additional elective deferrals made in previous years under the special rule.

Pre-TCA law provides a rule to coordinate the cumulative limit with the ability to make designated Roth contributions, but inadvertently reduces the \$15,000 amount by all designated Roth contributions made in previous years.

New law. The TCA clarifies that the \$15,000 amount is reduced only by additional designated Roth contributions made under the special rule.

■ **Designated Roth Contributions Are Subject to FICA**

Under pre-TCA law, elective deferrals are included in wages for purposes of social security and Medicare taxes.

New law. The TCA clarifies that wage treatment applies also to elective deferrals that are designated as Roth contributions.

■ **Revised Rules for Contributions of Appreciated Property by S corporations**

The 2006 Pension Protection Act (PPA) amended the S corporation rules so the decrease in a shareholder's basis in his S corporation stock by reason of a charitable contribution made by the S corporation equals the shareholder's pro rata share of the adjusted basis of the contributed property. This rule applies for contributions made in

tax years beginning after 2005 and before 2008.

Observation: Under the pre-2006 PPA rules, when an S corporation made a charitable contribution of appreciated property, the shareholder's basis was reduced by the fair market value of the property. When the shareholder sold his stock, the basis reduction caused him to recognize more gain. This result differed from that of a direct charitable contribution of appreciated property, which didn't result in any gain recognition by the contributor.

New law. The TCA provides that, where the above rule applies to limit the decrease in the basis resulting from the charitable contribution, the rule which limits the aggregate amount of losses and deductions which may be taken by the S corporation shareholder to his basis in the S corporation's stock and debt does not apply to the extent of the excess (if any) of:

- the shareholder's pro rata share of the charitable contribution, over
- the shareholder's pro rata share of the adjusted basis of such property.

Illustration: A 100% shareholder in an S corporation has a \$300 basis in his S corporation stock. The S corporation contributes property with a basis of \$200 and a fair market value of \$500 to a charity. Under pre-TCA law, the shareholder could only take a \$300 deduction for the contribution, since his basis in the stock was \$300. The TCA allows the shareholder to take a full \$500 deduction. The shareholder reduces his basis in his S corporation stock from \$300 to \$100.

■ **Look-through Rule Clarified for Related CFCs**

U.S. persons who are 10% shareholders of a controlled foreign corporation (CFC) are required to include in income their pro rata share of the CFC's subpart F income whether or not this income is distributed to the shareholders. Subpart F income includes foreign base company income (FBCI), which in turn includes foreign personal holding company income (FPHCI). For subpart F purposes, FPHCI includes dividends, interest, income equivalent to interest, rents and royalties.

A look-through rule provides that a FPHCI doesn't include dividends, interest, rent and royalties received or accrued from a CFC which is a related person to the extent attributable or properly allocable to income of the related person which is neither subpart F income nor income effectively connected to a trade or business. Under the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA), the look-through rule applies for tax years of foreign corporations beginning after December 31, 2005, and before January 1, 2009, and tax years of U.S. shareholders with or within which such tax years of foreign corporations end.

The IRS concluded the look-through rule didn't apply to interest, rent or royalties if deductions for those amounts created (or increased) a deficit which reduced the subpart F income of the related CFC payor or another CFC.

New law. The TCA provides that the look-through rule doesn't apply to any interest, rent or royalty to the extent it creates (or increases) a deficit which under Code Section 952(c) may reduce the subpart F income of the payor or another CFC. Thus,

interest, rents and royalties will be treated as subpart F income, notwithstanding the general look-through rule, if the payment creates or increases a deficit of the payor corporation and that deficit is from an activity which could reduce the payor's subpart F income under the accumulated deficit rule or could reduce the income of a qualified chain member under the chain deficit rule.

Observation: Thus, the technical correction conforms the Code to IRS's guidance.

■ **Modification of Section 355 Active Business Definition**

One of the requirements for a tax-free Code Section 355 corporate division (e.g., a spin-off) in which a distributing corporation (D) distributes a controlling interest in its subsidiary (C) to one or more D shareholders is that immediately after the distribution D and C must each be engaged in the active conduct of a trade or business. Under pre-TCA law, among other requirements, D and C had to satisfy the active business test under Code Section 355(b)(2)(a):

- (1) the corporation had to be engaged in the active conduct of a trade or business, or
- (2) substantially all of its assets had to consist of stock and securities of a corporation (or corporations) it controlled immediately after the distribution and the controlled corporations were engaged in the active conduct of a trade or business.

TIPRA provided that, for distributions made after May 17, 2006, a corporation was only treated as satisfying the active business test if, and only if, it was engaged in the active conduct of a trade or business. In applying this requirement, all members of the corporation's "separate affiliated group" were treated as one corporation. Thus, the active business test was applied on a group basis to each separate affiliated group.

Observation: As a practical matter this replaced the item (2), above, under the active business test.

A corporation's separate affiliated group is the affiliated group that would have existed under Code Section 1504(a) (generally requiring ownership of stock with 80% of the voting power and 80% of the value) if the corporation were the common parent and the Code Section 1504(b) exclusions (e.g., for insurance companies and foreign corporations) did not apply. All corporations which satisfied this test were included in the separate affiliated group.

A special transition rule applied for determining the continued qualification under the Code Section 355(b)(2) business test for a pre-May 18, 2006, distribution where there was a post- May 17, 2006, acquisition, disposition or other restructuring. Under Code Section 355(b)(3)(D), the distribution was treated as made on the post- May 17, 2006, acquisition, disposition or restructuring date in applying the above separate affiliated group rule.

Under Code Section 355(b)(2)(C), another requirement for satisfying the Code Section 355(b)(2) business test is that the trade or business must not have been acquired within a 5-year period in a transaction in which gain or loss was recognized. Under an

exception to this rule, if a purchased trade or business represents an expansion of a business conducted by the separate affiliated group, the expansion trumps the taxable purchase and the purchased business immediately qualifies as a good active business. However, under pre-TCA law, if the acquisition was a stock acquisition, the expansion exception couldn't apply.

New law. The TCA removes from the Code item (2), above, of the Code Section 355(b)(2)(A) active business test.

Observation: This provision was only relevant following the scheduled sunset of the affiliated group rule. Once that rule was made permanent by the 2006 Tax Relief Act, item (2) of the Code Section 355(b)(2)(A) active business test became "deadwood."

The TCA clarifies that, in determining if a corporation meets the Code Section 355(b)(2)(A) active business test, all members of the corporation's separate affiliated group are treated as one corporation.

Observation: This separates the separate affiliated group rule from the definition of a separate affiliated group. The former language was subject to possible confusion as to whether it may have created a special active business rule

The TCA also provides that, if a corporation becomes a member of a separate affiliated group by reason of one or more transactions in which gain or loss was recognized in whole or in part any trade or business conducted by the corporation when it became a member, it will be treated as acquired in a transaction in which gain or loss was recognized in whole or in part. Thus, such a stock acquisition is subject to the provisions of Code Section 355(b)(2)(C), and may qualify as an expansion of an existing active trade or business conducted by the distributing corporation or the controlled corporation, as the case may be.

Under the TCA, IRS is to issue regulations to carry out the purposes of the above amendments.

The TCA clarifies that the provision on the application of the new rules to determine the continued qualification under Code Section 355 of a distribution which occurred before the effective date of the new rules, will apply only if it results in continued qualification and is not intended to require application of the new rules in a manner which would disqualify any distribution which satisfied the Code Section 355 active business requirements under prior law which was applicable to the distribution.

While the above changes are generally effective for distributions after May 17, 2006, transition rules (most of which were contained in the pre-TCA law) apply, unless the distributing corporation elects otherwise.

■ **Partnerships Treated as Leases and the Tax-exempt Loss Rules**

Code Section 470 generally applies loss deferral rules to property leased to tax-exempt entities. This rule applies for tax-exempt use property, which generally has the meaning given to the term by Code Section 168(h) (with exceptions specified in

Code Section 470(c)(2)). Tax-exempt use property, for purposes of the tax-exempt use loss rules, includes most property leased to tax-exempt organizations, governmental units or certain foreign individuals or entities. Certain qualifying leases are excepted from the tax-exempt use loss rules.

Under the American Jobs Creation Act of 2004 (AJCA), there was no express reference to Code Section 7701(e) in determining whether a partnership was a lease for purposes of the tax-exempt use loss rules.

New law. The TCA provides that tax-exempt use property doesn't include any property which would be tax-exempt use property solely by reason of Code Section 168(h)(6). The TCA provision refers, via a cross-reference, to Code Section 7701(e) for circumstances in which a partnership is treated as a lease to which Code Section 168(h) applies. Thus, if a partnership is recharacterized as a lease under Code Section 7701(e), and a provision of Code Section 168(h) (other than Code Section 168(h)(6)) applies to cause the property characterized as leased to be treated as tax-exempt use property, then the Code Section 470 loss deferral rules apply.

Observation: The TCA provision removes any doubt that, to the extent that being leased is one of the elements of being tax-exempt use property for purposes of the tax-exempt use loss rules, that element is present where an arrangement is in the form of a partnership, but is, in substance, a lease.

Under Code Section 7701(e)(2), a partnership may be treated as a lease, taking into account all relevant factors, including factors similar to those set out in forth in Code Section 7701(e)(1) (relating to service contracts treated as leases). For property of a partnership in which a tax-exempt entity is a partner, factors similar to those in Code Section 7701(e)(1) (and in its legislative history) that are relevant in determining whether a partnership is properly treated as a lease of property held by the partnership include:

- whether a tax-exempt partner maintains physical possession or control or holds the benefits and burdens of ownership with respect to the property;
- whether there is insignificant equity investment by any taxable partner;
- whether the transfer of the property to the partnership doesn't result in a change in use of the property;
- whether the property is necessary for the provision of government services;
- whether a disproportionately large portion of the deductions for depreciation with respect to the property are allocated to one or more taxable partners relative to the partner's risk of loss with respect to the property or to the partner's allocation of other partnership items; and
- whether amounts payable on behalf of the tax-exempt partner relating to the property are defeased or funded by set-asides or expected set-asides.

It is intended that regulations or other IRS guidance will provide additional factors which can be taken into account in determining whether a partnership with taxable

and tax-exempt partners is an arrangement which resembles a lease of property under which Code Section 470 defers the allowance of losses.

It is not intended that for tax years of partnerships beginning in 2004, 2005 and 2006, the TCA provision supercede IRS notices which state that IRS will not apply Code Section 470 to disallow losses associated with property which is treated as tax-exempt use property solely as a result of the application of Code Section 168(h)(6), and that abusive transactions involving partnerships and other pass-through entities are subject to challenge. Accordingly, for partnership tax years beginning in 2004, 2005 and 2006, IRS may apply Code Section 470 to a partnership which would be treated as a lease under Code Section 7701(e)(2).

This Hot Topic is an informative publication for our clients and friends of the Firm. It is designed to provide accurate information on the subject matter covered. We recommend you consult with your legal and other advisors to determine if the information is applicable in your specific circumstances. If these advisors are not available to you, please feel free to contact Barry N. Finkelstein, CPA at 972/934-1577 or e-mail at info@facpa.com.