Significance of Technical Corrections Legislation

Assume it is 1987 and you are preparing your individual client's Form 1040. The Tax Reform Act of 1986 contained numerous provisions effective for 1987 that you must deal with for the first time. Congress is again working on legislation to make even more changes to the Internal Revenue Code, including some it has labeled as "technical corrections" to the 1986 tax act.

Your client has a principal residence and a vacation home. The mortgage interest on the vacation home was $20,000 in 1987. Your client does not rent the home out and used it for less than 15 days in 1987. You are pondering over whether the $20,000 of interest is deductible because you have found the following three items:[1]

1) IRC §165(h)(5)(A) Qualified Residence - For purposes of this subsection,

(i) In General - The term "qualified residence" means -

(I) the principal residence (within the meaning of section 1034) of the taxpayer, and

(II) 1 other residence of the taxpayer which is selected by the taxpayer for purposes of this subsection for the taxable year and which is used by the taxpayer as a residence (within the meaning of section 280A(d)(1)).

(iii) - "Residence Not Used or Rented - For purposes of clause (i)(II), notwithstanding section 280A(d)(1), if the taxpayer does not rent or use a dwelling unit at any time during a taxable year, such unit may be treated as a residence for such taxable year."

[This leads you to the opinion that for 1987, the interest is personal interest and only 65% deductible because the client did not use the home personally for more than 14 days during 1987 and it was not vacant during the year.]

2) General Explanation of the Tax Reform Act of 1986 (Blue Book) prepared by the staff of the Joint Committee on Taxation and released May 7, 1987, page 267 and footnote 64 explaining the new home mortgage interest deduction rules:

- "A second residence of the taxpayer includes a dwelling unit used by the taxpayer as a residence within the meaning of section 280A (gain on which could qualify for rollover treatment under section 1034 if the residence were used as a principal residence). If a second residence is not rented at any time during the taxable year, the taxpayer need not meet the requirement of section 280A(d)(1) that the residence be used for personal (non-rental) purposes for the greater of 14 days or 10 percent of the number of days it is rented. [fn64]"

- "fn 64 - A technical correction may be needed so that the statute properly reflects this intent. Such a correction was included in the versions of H. Con. Res. 395 that passed the House and the Senate in the 99th Congress."

[Now you think there may be some possibility of treating the $20,000 as fully deductible mortgage interest.]

3) Current technical corrections legislation by which Congress plans to,

- remove "used or" after "not" in the heading of §165(h)(5)(A)(iii)
- remove "or use" after "rent" in the text of §163(h)(5)(A)(iii)

[1] Note: Subsequent to 1987, the numbering of the provisions has changed at §163(h).

You also note that Congress calls the proposed change a "clarification" to the original rule in the 1986 Act and that it would be effective as if it had originally been in the 1986 Act.

Based on all of the above, you are convinced that the $20,000 is fully deductible, BUT, the Technical Corrections bill may not be enacted for some time (it was enacted November 10, 1988), and you need to get the return filed. What do you do? Follow current law, which makes the $20,000 personal interest, and later file an amended return (which will cost your client), or follow the proposed correction which allows the interest to be fully deductible, and hope that the proposal gets passed?

As Congress makes numerous and complex changes to the tax law, the above scenario becomes all too common. It puts practitioners in the difficult position of having to decide to follow existing law which appears to be in error, or taking a position that is not yet part of the law. Would your position be the same if the results were opposite, that is, the apparent error is in your client's favor and the proposed correction is not? That scenario adds an additional twist. For example, you file the return following existing law which results in a $4,000 deduction to your client. Two years later, the law is "clarified" whereby your client should only have taken a $1,000 deduction. There is no requirement in the law that a taxpayer must amend a tax return. Treasury Circular 230 and other rules of conduct tell you that you should recommend that the client amend. Also, should your client's return be examined by the IRS, they would make the change and your client would owe tax plus interest. What do you do?

The outcomes of such situations are not easy to predict. For example, the Omnibus Budget Reconciliation Act of 1989 made changes to the like-kind exchange rules for exchanges between related parties. The changes were to be effective for transfers after July 10, 1989. In defining related parties, the Act only referred to the §267(b) definition, which excludes certain partner/partnership relationships. Many thought that was just a drafting error, which would be corrected later with an effective date as if it had been part of the 1989 Act. This perceived "error" made many practitioners leery of what to do - should they assume that the correction would be retroactive and avoid such exchanges, or should they assume it would not be a retroactive change and quickly proceed with such exchanges before they became restricted under §1031. Congress did correct the §1031 language to include a reference to §707(b)(1) in defining related parties (Omnibus Budget Reconciliation Act of 1990), BUT, the effective date of the addition was for transfers after August 3, 1990!

Sometimes problems with respect to technical corrections arise years later when the corrections act is passed several years after the original law was enacted, and the correction is retroactive. An example of this is *Wiggins v Comm'r*, 90-2 USTC §50,362, 66 AFTR2d 5225 (5th Cir). In 1983, the Wiggins sold property which resulted in some investment tax recapture. They were also subject to alternative minimum tax (AMT) in 1983. AMT is the amount by which tax under the AMT rules exceeds regular tax. In 1983, the definition of regular tax did not exclude investment tax recapture. Thus, the taxpayer included the recapture in their regular tax and paid reduced AMT, or, in effect, did not have to pay the recapture tax. In 1984, Congress amended the definition of regular tax for these purposes to exclude recapture from regular tax. This was done in the 1984 Tax Act and corrected the 1982 Tax Act. Congress made the effect of the change retroactive as if it had been part of the 1982 Act. The IRS assessed the Wiggins an additional amount of tax equal to the recapture tax of $3,986. The taxpayers challenged the retroactive change as an unconstitutional taking of property without due process under the Fifth Amendment. They also argued that if the amendment were really a technical correction, Congress would have made the correction as soon as possible instead of waiting over one year.

The Wiggins lost in both the Tax Court and the Fifth Circuit Court of Appeals. The Fifth Circuit Court made the following comments:

- Congress was aware soon after the passage of TEFRA which changed the AMT calculations that a correction was needed because of the potential for the problem such as the Wiggins later encountered. The need for a technical correction was noted in the Blue Book to the 1982 tax act (TEFRA).

- "The possibility that Congress may have chosen not to enact curative legislation in 1979 does not make the legislation any less curative in 1984. Even if Congress believed the statute needed no correction in 1979, Congress viewed the 1984 amendment as a correction necessary to effectuate its intent in enacting TEFRA in 1982, which completely revised the computation of the alternative minimum tax."

- Relying on other court decisions, the court stated, "Where legislation is curative, retroactive application may be constitutional despite a long period of retroactivity."

- The amendment should have been part of TEFRA from the beginning. Because the amendment is curative, the fact that the effective date is some eighteen months before enactment does not make its retroactive application harsh and oppressive."

What to do when faced with such situations:

There is no clear answer here! Technical corrections to a tax act often use terms such as "clarifying" or "correcting errors," which signify that the change to be made was probably intended to be part of the law from the start. In such cases, you might feel more comfortable following the technical correction even though it is not yet part of the law. Other provisions in a technical corrections act use the words "modifying" or "making amendments," where it is not clear that the rule was intended to be part of the original act.

When faced with situations described above, it is important to review the legislative history to the original act and the Committee Reports to the technical corrections bill (assuming it is not yet enacted by the time you file the tax return) to make your best determination of the proper rule to follow. It is also a good idea to explain the situation to your client.