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One Elk Street, Albany, New York 12207 • 518/463-3200



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September 18, 1998

The Honorable Donald C. Lubick
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

The Honorable Charles O. Rossotti
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Dear Secretary Lubick and Commissioner Rossotti:

I am pleased to enclose a report of the New York State Bar Association Tax Section commenting on proposed regulations dealing with qualified subchapter S subsidiaries ("QSSS").

We believe that the proposed regulations do a good job of describing the consequences of making and terminating a QSSS election. However, we are concerned that the broad application of the step-transaction doctrine in the proposed regulations may result in adverse tax consequences that could have been avoided with more careful planning. This is particularly troublesome for small businesses, which are often organized as subchapter S corporations and may not have access to sophisticated tax advisors. We, therefore, recommend that the final regulations limit the application of the step transaction doctrine in the case of the making and termination of QSSS elections.

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assets immediately before such cessation "from the S corporation" in exchange for its stock. Similarly, we are aware that such provision is intended to conform to the rules governing qualified REIT subsidiaries under Section 856(i).²¹

Nevertheless, we believe Section 1361(b)(3)(C) can be limited to cases in which the S corporation continues to own 100% of the stock of the former QSSS following a termination event that includes revocation of an election. The statutory language does not appear specifically to contemplate the case where termination of the QSSS election occurs by reason of a sale of the stock to a third party. The statutory language, in any event, does not address the step-transaction doctrine. Although we believe that clarification of the statutory authority for our recommended approach should be unnecessary, we believe a technical correction to Section 1361(b)(3)(C) to permit regulatory exceptions thereto would be appropriate to the extent considered necessary to provide the requisite statutory authority.

21. The legislative history to Section 856(i) contemplates that a sale by a REIT of all the stock of a qualified REIT subsidiary to a third party would be a "busted" Section 351 transaction. H.R. Rep. No. 99-481, 99th Cong. 2d Sess., at II-214.