NEW YORK STATE BAR ASSOCIATION
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September 9, 2013

The Honorable Mark Mazur
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Department of the Treasury
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Daniel I. Werfel
Principal Deputy Commissioner
Internal Revenue Service
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The Honorable William J. Wilkins
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Re: Report on Proposed Regulations Under Section 172(h) Relating to Corporate Equity Reduction Transactions

Dear Messrs. Mazur, Werfel and Wilkins:

We are pleased to submit the attached report of the Tax Section of the New York State Bar Association regarding the proposed corporate equity reduction transaction ("CERT") regulations issued on September 13, 2012 (the "Proposed Regulations").

The CERT rules were enacted to prevent the use of a net operating loss ("NOL") carrybacks to finance leveraged transactions. Under current law, if a corporation engages in a major stock acquisition ("MSA") or an excess distribution ("ED"), the portion of the NOL incurred in a "loss limitation year" ("LLY") attributable to interest related to the CERT (the corporate equity reduction interest loss or "CERIL") cannot be carried back to any taxable year prior to the year of the CERT. As summarized below, this Report provides a number of comments and recommendations on several technical and policy issues raised by the Proposed Regulations.

The Proposed Regulations consist of Prop. Reg. §§1.172(h)-0 through 1.172(h)-5, Prop. Reg. §1.1502-72, and certain proposed amendments to existing Reg. §1.1502-21. As summarized below, we generally support the Proposed Regulations, which provide much-needed guidance on the CERT provisions in the Code. The attached report provides the following comments and recommendations on several technical and policy issues raised by the Proposed Regulations:

1. The Proposed Regulations provide that a stock-for-stock acquisition is a CERT. Because such acquisitions generally do not reduce corporate equity, we recommend that final regulations exclude them from the CERT limitations. One way to do so would be to exclude the stock portion of the consideration as a CERT cost. As an alternative to excluding stock consideration as a CERT cost, final regulations could exclude stock-for-stock acquisitions from the definition of an MSA (except to the extent of any boot). If desired, to achieve parity among economically equivalent transactions, final regulations could also adopt correlative rules that: (i) decrease the pool of costs treated as arising from a CERT ("CERT costs") by the proceeds of any share issuance made in connection with a cash acquisition, and (ii) increase CERT costs by the costs of any share redemption made in connection with a stock-for-stock acquisition. To avoid the complexity associated with developing rules to establish when a share issuance or redemption is made "in connection with" a CERT, final regulations could provide that any such issuance or redemption will be integrated with a CERT only if it occurs within six months of the CERT.

2. The Code expressly exempts stock acquisitions treated as asset acquisitions under section 338 from the definition of a CERT, thereby clearly evidencing Congressional intent to exclude asset acquisitions. An asset acquisition may nevertheless be treated as a CERT in certain circumstances (e.g., a tax-free merger may be considered an ED of the target corporation succeeded to by the acquiring corporation). Given the economic similarity between tax-free asset and stock acquisitions, final regulations could include tax-free asset acquisitions in the definition of a CERT, but exclude the stock consideration as a CERT cost. Alternatively, if final regulations exclude tax-free asset acquisitions entirely, we recommend that they clarify that the actual or deemed distribution by the target corporation of the consideration received from the acquiring corporation is not an ED.

3. The Proposed Regulations provide that a CERT includes transactions qualifying under section 351. Because these transfers do not reduce the equity of the corporate transferor, we recommend that final regulations exclude them from the definition of a CERT.

4. The Proposed Regulations also treat a tax-free spin-off under section 355 as a CERT. Under one view of these transactions, a spin-off should not be treated as a CERT because it merely divides corporate equity into smaller pieces without reducing aggregate corporate equity (except to the extent of any boot). Under an alternative view of these transactions, a spin-off should be treated as a CERT because it separates the leverage (whether existing or newly incurred) from the historic income pool of the distributing and controlled businesses, which may generate NOL carrybacks in the more leveraged entity. If final regulations follow the Proposed Regulations, we recommend that they modify the apportionment methodology to allocate a larger percentage of the CERT costs to the more leveraged entity.

5. We recommend that final regulations clarify that a stock distribution under section 305 (whether taxable or tax-free) is not an ED. Such stock distributions merely divide corporate equity into more units and do not reduce aggregate corporate equity.

6. We support treating a distribution by a target corporation as part of an MSA where the distribution and the MSA are part of the same plan, regardless of whether such distribution also constitutes an ED if tested independently. We recommend that final regulations clarify that a redemption of acquiring corporation stock in connection with an MSA is not considered to be part of the same integrated plan as the MSA, so that such redemption is tested separately as an ED.

7. Under current law, preferred stock described under section 1504(a)(4) is disregarded for purposes of determining whether an ED has occurred (i.e., the redemption of such stock is not an ED and the issuance of such stock does not offset other distributions). We suggest that Treasury and the IRS consider expanding the definition of preferred stock to include voting preferred stock that is otherwise described in section 1504(a)(4). Alternatively, consideration could be given to abandoning the definition of preferred stock under section 1504(a)(4) in favor of the definition under section 351(g), which we believe more precisely captures the type of preferred stock that Congress intended to exclude from the ED rules.

8. The Proposed Regulations include a special rule treating borrowing costs on debt that facilitates an MSA or ED as CERT costs. We recommend that final regulations treat borrowing costs on all debt (whether or not it facilitates a CERT) as interest expense for this purpose.

9. The Code provides that indebtedness is allocated to a CERT in the manner prescribed under section 263A(f)(2)(A)(ii), but without regard to section 263A(f)(2)(A)(i), which provides for tracing of certain debt (the "Avoided Cost Method"). We generally support the Avoided Cost Method and do not recommend the adoption of a tracing methodology as a general alternative. To mitigate the occasional harshness of the Avoided Cost Method, however, we recommend that Treasury and the IRS explore whether an administrable rule could be devised that would permit tracing in limited circumstances (e.g., when a target corporation with debt outstanding joins the group in an MSA), or that would adopt another presumption (such as pro rata allocation of sources of funds to expenditures).

10. If a taxpayer experiences an unforeseeable extraordinary adverse event (an "Unforeseeable Event") following a CERT, debt is first allocated to costs associated with such event, rather than to the CERT. We recommend that any regulatory definition of Unforeseeable Event adopt an objective standard and be limited to events (i) with a low probability of occurrence (no more than one-in-ten) at the time of the CERT; (ii) that arise from circumstances beyond the taxpayer's control; and (iii) that create an unexpected need for excess expenditures or an unexpected loss in revenue.

11. Under current law, the amount of the CERIL for any LLY is capped (the "CERIL cap") at the excess (if any) of (i) the amount allowable as an interest deduction during the LLY, over (ii) the average of such amounts for the three taxable years preceding the taxable year of the CERT. The Proposed Regulations provide that in the event of a short LLY, the three-year average is prorated by the number of days in the short LLY. Furthermore, if a corporation was not in existence for three taxable years preceding the taxable year of the CERT (the "interest lookback period"), the corporation is deemed to have been in existence for periods during which it accrued no additional interest. To avoid understating the historic interest expense of such corporations, we recommend an adjustment comparable to the adjustment made for a short LLY.

12. The preamble to the Proposed Regulations requests comments on how final regulations should factor out the impact of fluctuations in interest rates following a CERT. We recommend that final regulations adjust the three year interest history (and correspondingly the CERIL cap) upwards or downwards based on changes in the applicable federal rates. In effect, the limitation would be multiplied by a fraction, the numerator of which would be the average of the federal mid-term rates for the LLY and the denominator of which would be the weighted average of the applicable mid-term federal rates for the interest lookback period. The CERIL cap would therefore be increased if the fraction is greater than one and reduced if the fraction is less than one.

13. The Proposed Regulations adopt single entity rules for consolidated groups. If a corporation joins a consolidated group, the group inherits the CERT attributes of that member. When a corporation departs from a consolidated group, the CERT attributes of the group are generally apportioned to the departing member based on relative net fair market values. We believe consideration should be given to other allocation methods, such as the relative gross fair market value of assets or the relative amount of indebtedness of the departing and remaining members. We also recommend that the group's distribution and share issuance histories be apportioned to the departing member based upon the relative net fair market values of the departing and remaining members.

14. The Proposed Regulations disregard intercompany transactions between group members unless they occur pursuant to a plan in which a party to the transaction becomes a non-member. We recommend that final regulations generally eliminate the "pursuant to a plan" exception.

15. A departing member may make a unilateral election to relinquish the carryback of all NOLs to taxable years of its former consolidated group and any preceding years. In such a case, none of the CERT history or attributes of the group are apportioned to the departing member. In the absence of such an election, the required apportionment of CERT attributes to the departing member will compel selling groups to provide substantially more information to the departing member. We nevertheless recommend that final regulations retain the default rule because it is consistent with the default rule for other carryback elections.

16. Finally, we recommend that taxpayers be permitted to apply the final regulations retroactively, providing that they do so consistently for all CERTs undertaken prior to the effective date of the final regulations.

We appreciate your consideration of our recommendations. If you have any questions regarding this report, please feel free to contact us and we will be glad to discuss or assist in any way.

Respectfully submitted,

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Chair

Andrew W. Needham
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Enclosure

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