REPORT #904

TAX SECTION

New York State Bar Association

Comments the Tax Simplification
Proposals Announced by the Treasury
Department on April 14, 1997

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TAX SECTION

New York State Bar Association

May 22, 1997

Honorable Donald C. Lubick
Acting Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW, Room 3120
Washington, DC 20220

Dear Secretary Lubick:

Attached is a report containing comments submitted by members of the Tax Section on the Simplification Proposals announced by the Treasury Department on April 14th. In general, the report commends the Proposals and believes that their enactment will serve to make the law simpler and less complex and will ease the burden of taxpayer compliance. However, we do have comments on certain of these proposals, and they are set forth in the report.

As noted in the report it reflects individual comments by members of the Tax Section and has not been approved by the Tax Section. Nevertheless, we hope it will be helpful to you.

Of course, we will be available to work with you and your staff in developing these Proposals. Please contact me if we can be of assistance.

Very truly yours,

Richard O. Loengard, Jr.
Chair

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New York State Bar Association

Tax Section

Comments the Tax Simplification

Proposals Announced by the Treasury

Department on April 14, 1997

This report[1] contains comments of members of the Tax Section of the New York State Bar Association on the Tax Simplification Proposals announced by the Treasury Department on April 14th. Obviously these are preliminary comments based on the explanation of those proposals issued by the Treasury Department on April 16th, and additional comments may be made when the statutory language of the proposed amendments is available.

Our principal comment on the simplification proposals is that in most instances they are most welcome and will serve to make taxpayer compliance with the law simpler. In general, we applaud the effort by the Treasury to eliminate unnecessary complexity in the law in this fashion.

For example, elimination of the principal office requirement under Section 864 will make compliance with that provision far easier and less expensive without adversely impacting revenues. Similarly, we believe that repeal of Section 1491 of the Code will eliminate a provision which has been infrequently invoked but threatened to trap the unwary; we agree that other provisions of the law, many of them introduced since Section 1491 was enacted, will serve to protect the revenue. We

[1] The report reflects comments received from Andrew Berg, Kimberly Blanchard, Dale Collinson, David Hariton, Michael Hirschfeld, Carolyn Joy Lee, David Miller, Linda D'Onofrio, Yaron Reich, Marc Silberberg, Alan Tarr, Ann Thomas, and Patti Wu. It was edited by Richard O. Loengard, Jr. and Deborah Paul. It has not been approved by the Tax Section.

also commend the proposals relating to tax-exempt bonds which will simplify compliance with those provisions.

Nonetheless, we do have some comments, which we hope will be helpful:

1. Partnership Adjustments. The proposals relating to the effect of partnership adjustments reflect portions of the Tax Simplification Act of 1995 (a bill which was not enacted) to which we objected at the time. We still believe our criticism is valid, and there is attached hereto a copy of the letter which Carolyn Lee, then Chair of the Tax Section, wrote in opposition to those portions of the 1995 bill.

2. Subchapter S Conversions. We generally applaud the proposal to facilitate the efficient conversion of certain S corporations to partnership status, which we understand would permit such conversion on payment of the tax on built in C corporation gain, without tax at the corporate level on other gain or tax at the shareholder level. However:

(a) We would suggest that the provisions of the law be extended to transactions in which an S corporation in fact converts, through liquidation, merger or otherwise, into a limited liability company or partnership.

(b) We would also suggest that the statute make clear the impact of the election on the tax basis and holding period of the S corporation’s assets, on the tax basis of the S corporation’s stock in the hands of a stockholder/partner following conversion, and on the treatment of the S corporation as a partnership after the election.

(c) The details of the election are unclear; we would hope that it can be made, as is true in the case of the subchapter S-election, retroactively to the beginning of the year so that two returns do not have to be filed for the year in which the election becomes effective.

3. Foreign. We generally applaud the proposed simplification in the foreign area. As indicated above the elimination of the principal office requirement will vastly simplify the operation of many foreign entities investing in the United States and will thus encourage foreign investment in the United States in furtherance of the purposes of Section 864. However, we do have certain suggestions concerning other proposed rules.

(a) Individual Foreign Tax Credit Limitations

We support the proposal to exempt certain individuals from the foreign tax credit limitation.

We observe, however, that in view of its intended purpose, the proposed limit for this exemption ($300 of foreign tax credits per annum for individuals, and $600 for married couples filing jointly) is relatively low. An individual might reach this limit holding less than $30,000 worth of foreign stock assuming, for example, dividends of 7% per annum and a 15% foreign withholding tax. We are mindful that, in light of inflation, any such cap will effectively become smaller over time, and Congress may not be in a position to periodically revisit this limitation.

We therefore recommend extending the proposed exemption to individuals with more than the projected level of foreign tax credits, for example, those with $1,000 of creditable foreign taxes in any given year ($2,000 for married couples filing jointly). It seems to us unlikely, even based on today's dollars, that such an exemption would lead individuals to engage in significant tax-motivated financial transactions. As the Treasury's explanation points out, most taxpayers who earn only passive foreign source income would be able to credit the relevant foreign withholding taxes in any case, because even in the case of leveraged holdings, the applicable foreign tax credit limitation will generally exceed the amount of foreign taxes paid.

In addition, since this proposal is not related to any transaction, we think that it would be consistent with its purposes to make it effective as soon as possible, that is for years ending after its enactment.

(b) Simplification of Controlled Foreign Corporation Rules

We commend the proposal to rationalize the treatment of dispositions of lower-tier foreign subsidiaries by treating such dispositions as resulting in deemed dividend inclusions, and by adjusting the basis of such subsidiaries for prior subpart F income inclusions. We likewise commend the proposal to proportionally reduce the subpart F income allocated to a U.S. shareholder who acquired a controlled foreign corporation from another U.S. shareholder in the middle of a taxable year.

We have reservations, however, regarding the proposal to permit U.S. taxpayers to obtain look-through treatment (for purposes of foreign tax credit limitations) for dividends which they receive from a controlled foreign corporation out of earnings accumulated while they were not U.S. shareholders of the controlled foreign corporation. We understand that the current law rule which causes such earnings to fall into a separate 10/50 basket is partly designed to prevent potential tax abuse. If this is repealed, then a U.S. taxpayer with excess foreign tax credit “capacity” (i.e., with excess limitation in the overall or financial service income basket) could, for example, (a) acquire all of the stock of a foreign-owned foreign corporation which has a large pool of accumulated earnings that have been subject to high foreign tax, (b) cause the newly acquired foreign subsidiary to declare a large dividend, (c) use the associated foreign tax credits to offset U.S. tax and (d) sell the foreign subsidiary at a substantial capital loss. As long as the accumulated earnings were originally derived from an active business, the associated credits would generally fall into the overall foreign tax credit limitation basket. If the relevant U.S. taxpayer was a financial service entity acquiring another financial services entity, the associated credits would generally fall into the financial services income basket, and the transaction might be easier to arrange, because the assets of the relevant foreign corporation might consist of a pool of easily valued financial assets.

If this proposal is ultimately adopted, therefore, we recommend that it be accompanied by a limit designed to prevent its use as outlined above. For example, dividends received out of earnings from years prior to the year in which the relevant U.S. taxpayer became a U.S. shareholder might be eligible for look-through treatment only to the extent that they did not exceed ten percent of the U.S. shareholder’s investment in the foreign subsidiary; compare § 1059(c)(2)(B).

(c) Exchange Rate Used in Translating Foreign Taxes

We support the proposal to simplify and reduce the burden of translating foreign tax accruals and payments into U.S. dollars for purposes of foreign tax credit limitations. The consequences of the proposal to permit accrual-basis taxpayers to accrue foreign taxes at the average exchange rate for the taxable year to which such taxes relate does not seem entirely clear to us, however. For example, the proposal do not appear to permit or require a taxpayer who elected such treatment (and whose functional currency was the U.S. dollar) to account for a difference, attributable to changes in exchange rates, between the amount of taxes accrued and the amount of taxes ultimately paid. Compare Treas. Reg. § 1.988-2(b)(3),-2(b)(4) (exchange gain or loss recognized on payment of previously accrued interest income or expense). Absent such an accounting, if the U.S. dollar value of the relevant foreign currency increased between the accrual period and the payment date, the taxpayer would not be permitted to deduct the resulting economic loss. Alternatively, if the U.S. dollar value of the relevant foreign currency declined, the taxpayer would not be required to include the resulting economic gain in income. Also, it is not clear what effect the taxpayer’s election to deduct, rather than credit, foreign taxes would have on such residual income or loss.

(d) Simplify Formation and Operation of International Joint Ventures

We applaud the proposal to repeal Section 1491 of the Internal Revenue Code. We agree that the provision serves no useful purpose other than to provide technical support for the reporting requirements of Section 1494(c). We assume moreover, that the new proposals for reporting by foreign partnerships, and reporting of certain transfers to foreign partnerships and trusts, would replace Section 1494(c) if this proposal were adopted, and Section 1494(c) would then be repealed. If that is the intention, however, it should be clarified.

We also are concerned that some of the proposed reporting obligations might force partners of foreign partnerships to provide information to the IRS which is redundant with information that will already be provided by the foreign partnership on Form 1065. We hope that the Treasury will seek to minimize the burden of compliance to whatever extent is still consistent with a workable system of reporting by U.S. partners and foreign partnerships.

Finally, in the case of the proposal concerning reporting of transfers to foreign partnerships, we suggest consideration be given to an exception for transfers of more than $100,000 per annum which occur in the ordinary course of the trade or business of the U.S. partner or the foreign partnership. We assume that there will already be adequate reporting of the income and gains of the foreign partnership on Forms 5471 and 1065 under the other rules contained in this proposal. Ongoing reporting of a large number of ordinary-course-of-business transactions between partners and partnerships would only serve to add an unnecessary reporting burden.

(e) Simplify 10-50 Corporation Foreign Tax Credit Limitation Baskets

We commend the proposal to merge the separate baskets for 10-50 corporations (other than PFICS) into a single basket. We agree that there is no reason to deny U.S. taxpayers he opportunity to cross-credit foreign source income derived from active joint ventures merely because they do not control the joint ventures.

We might take the logic somewhat further, however. We see no reason why U.S. taxpayers should not be permitted to characterize such income under look-through rules by reference to the income derived by the joint venture, provided that they can and do obtain and report the necessary information. Such treatment is already available for income from non-U.S.-controlled joint ventures that are treated as partnerships for U.S. tax purposes (a far more common occurrence with the advent of the “check-the-box” regime), and it is likewise available for income from U.S.-controlled foreign corporations, even if the relevant U.S. taxpayer possesses only 10 percent of the foreign corporation’s stock. We note that such treatment could likewise be extended to income from stock in a PFIC—the income would presumably be characterized primarily as passive income under the look-through rules.

We therefore recommend that U.S. taxpayers be permitted to elect look-through treatment for income from ownership of 10 percent or more of the stock of any foreign corporation, provided that they meet certain administrative requirements for the election. These requirements might include reporting by the relevant foreign corporation or impose reporting burdens on the U.S. taxpayer. Taxpayers who cannot, or do not, make the election would continue to be subject to a single 10-50 basket, and separate PFIC baskets, as under the current proposal.

(f) Mark-to-Market Method Option for PFIC Shareholders

We support the proposal to allow U.S. holders of marketable shares in a PFIC to account for income and loss from the stock on a mark-to-market basis. We understand that under the proposal in any year in which the market value of a share increases, that increase will be taxed as ordinary income to the shareholder; in the event the share decreases in value, the decrease will be allowed as an ordinary deduction to the extent of the prior income inclusion with respect to it and any excess will be carried forward and applied against subsequent increases in value. In the event that there is a loss on the investment, it will be a capital loss. We assume that the legislation will address details of the proposal, such as what shares qualify as marketable, how one determines market value, whether a decrease in value can be used to offset dividend distributions, etc. We also urge that the legislation make clear that any loss due to a decease in value is not subject to the 2% floor on miscellaneous itemized deductions.

(g) Definition of “Domestic” Trusts and Partnerships

We note the two proposals relating to the status of trusts and partnerships as domestic entities for purposes of the U.S. tax laws. We support the proposal relating to trusts. However, we would suggest that trusts organized after August 20, 1996 similarly be allowed to elect to be treated as domestic trusts, at least in cases in which there are one or more U.S. persons acting as a trustee.

In the case of the proposed definition of a domestic partnership, we understand that the principal concerns relate to the status of informal partnerships and of foreign entities which “domesticate” under state laws. Therefore, we are uncertain whether the grant of regulatory authority will be limited to dealing with these cases or will be broader. In any event we are concerned first, that the regulations authorized by the statute should not be retroactive in effect, converting entities which regard themselves as foreign into domestic entities, or visa versa, on a retroactive basis. Furthermore, we urge that, consistent with the proposal relating to trusts, existing partnerships be given an election to continue to apply existing law to determine their status as domestic or foreign, or alternatively be given some period of time in which to adjust their affairs so as to maintain their status under existing law. Compare the relief given in Notice 96-65 to pre-August 20, 1996 trusts. Finally, in view of the complexity of this area, we hope that the legislation will give the IRS flexibility in deciding on the scope and content of any regulations issued pursuant to it.

4. Individuals

In general, we support the proposed changes affecting individuals, with only a few caveats:

(a) While we support the elimination of the household maintenance test for the child and dependent care tax credit, we question whether its retention in the case of married persons filing separately is justified. For example, if a mother and young child live in the household of the mother’s parents, who contribute over half of the support of the household, her ability to claim the credit may depend on her filing status. We believe that the taxpayer who incurs the dependent care expense in connection with his or her employment should be eligible for the credit whatever his or her relative financial contribution to the household may be, provided the other requirements of section 21 are met. The disallowance of the credit for married couples filing separate returns places an unfair and unnecessary burden on the filing status decision.

(b) We have doubts about the wisdom of the proposal which would permit a de minimis exception to the passive loss rules. The proposal itself contains a number of exceptions to the exception: credits are not included, nor are losses from publicly traded partnerships. Furthermore, the exception is not available to any extent if a taxpayer has passive losses in excess of $1,000. Hence, we think that the de minimis rule may be difficult to administer and no simpler than existing law and in addition may invite more abuse than does present law. Furthermore, concern has been expressed that the relaxation in the strictures on tax shelters may have a long run deleterious impact out of proportion to any benefits the provision may produce.

(c) While we support the proposed amendment to exclude from income gains on the sale of a principal residence up to an amount of $500,000, we wonder whether the provisions of the current law should not be retained on an elective basis for those taxpayers who realize gain on such a sale which exceeds the statutory exclusion. This would apply to relatively few taxpayers, and those on a voluntary basis, so that the record keeping requirements of such a provision should not be unduly burdensome. In the long run it may be that the proposed amendment will protect all but a few taxpayers from tax on the sale of a personal residence, but at the present time, taxpayers, including those who have sold residences and reinvested for many years without recognizing gain, may easily have a relatively low basis and a gain in excess of the statutory limit (which, in the case of a single person, such as a widow or widower, is only $250,000). Consequently, we would suggest that existing law be continued on an elective basis. In addition to solving the transition problem, retention of existing law would seem desirable as a protection against the impact of inflationary and other changes in what can be a volatile housing market.

5. Section 1031 Exchanges

We commend the proposal to simplify and clarify the rules applicable to Section 1031 exchanges. These new rules would make Section 1031 exchanges significantly less complicated.

However, we do have several comments:

(a) The adoption of the one year bright line test in the proposal offers an added level of simplification by specifying the period of time (namely, one year) over which property must be held for productive use in a trade or business or for investment purposes. We believe that the final legislative language should clarify that such one year period applies to both the relinquished property as well as the acquired property.

(b) We also suggest that the holding period requirements adopt a flexible standard that reflects the decisions in Magnuson, 81 TC 763 (1983), aff'd, 753 F.2d 1490 (9& Cir. 1985) and Bolker, 81 TC 782 (1983), aff'd 760 F.2d 1049 (9th Cir. 1985). Compare Rev. Rul. 75-292, 1975-2 CB 333. This would allow for tacking the period of time over which the property has been held for the requisite use where properties may have been contributed to, or distributed from, a corporation or a partnership by or to its shareholders or partners either before or after the exchange. In view of the large number of real estate properties that are held in partnership form and the difficulties that are sometimes experienced in structuring like kind exchanges for partnerships where the parties do not wish to continue in that same form of ownership after the transaction, this proposal would truly offer both simplification and practicality to these commonly encountered transactions. This protection would be limited to situations where the transferee continues to hold the property for the balance of the one year holding period. We recognize that these transactions may also result in a shifting of ownership of the underlying properties, as where certain, but not all, of the partners may receive the acquired property from a partnership after a like kind exchange has occurred; nonetheless, we believe that if such partners continue to hold the acquired property for the balance of the one year period then the abuse for "cashing out" from a like kind exchange has been avoided.

(c) We are concerned about the adoption of the change in the standard for like kind exchanges. Because of its longstanding history and the well developed body of law under Section 1031, it is difficult to consider a change to the Section 1033(g) standard as being simplification. The Section 1031 definition is easily administrable and has attracted little or no criticism from a simplification perspective from tax practitioners, the real estate industry or, previously, the government. Moreover, we note that presently, Code Section 1033(g) adopts a standard of "similar or related in service or use" for real estate but only for condemnation transactions. Other types of involuntary conversions are permitted to use the more flexible standard of Section 1031.

We presume that the reason for revising this standard is that, from a policy perspective, the standard is regarded as too generous. While this is ultimately an issue of tax policy, we do note that this standard has been in the Code since 1924. Given the long history of this provision, we do not believe that its revision is appropriate without a careful review of what effects such a change may have.

We also find the reasons given for the change unclear. For example, we are not clear why the fact that parties to a like kind exchange may agree on a value of the property is a reason to change the standard in a manner which may impact transactions in which this is not the case. Similarly, the fact that the new property may provide the taxpayer with a greater degree of liquidity does not seem controlling since the taxpayer similarly could have borrowed against the old property without incurring a tax. Further consideration of these issues therefore seems desirable before long standing rules are changed.