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NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON SIMPLIFICATION

OF THE

INTERNAL REVENUE CODE

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New York State Bar Association
Tax Section

Report on Simplification of the Internal Revenue Code

I. Introduction

A great deal of thoughtful commentary, as well as rhetoric, has been devoted of late to the topic of the complexity of the U.S. income tax system and the need for simplification. We hope to avoid adding to the rhetoric, and have only modest contributions to make toward an overview of the subject. The principal purpose of this report is to suggest a short list of topics we believe are ripe for simplification.[1] The list includes well-known problem areas affecting millions of taxpayers, such as the individual alternative minimum tax. Other topics, such as technical aspects of the active business requirement of Section 355, affect far fewer taxpayers but result in unnecessary complexity in structuring accepted business transactions. Still others, such as the collapsible corporation rules, might be termed nuisances. Whether the rules in question produce major problems or mere nuisances, we consider them "ripe" because we believe simplification could be accomplished without compromising important tax policies.

The list we offer is not meant to be comprehensive; it is skewed toward issues with which our members are most familiar. For instance, we do not address the subjects of the earned income tax credit, the varying definitions of "qualifying child," or the complexities of calculating the taxable portion of social security benefits. In all of these areas, persuasive cases have been made that

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[1] This report reflects input from many of the members of the Executive Committee of the Tax Section. David Miller organized the project that led to this report and participated substantially in drafting, as did Sam Dimon.

complexity is a problem and that appropriate simplification should be considered. Important as these topics may be, we do not believe we can add meaningfully to the thoughtful discussions of these areas by others.

The topics discussed in this report are fairly specific in nature. We also are willing to contribute to discussions of more far-reaching reforms. For instance, we recently commented on the Treasury's "Subpart F" study[2] and would be pleased to participate in further dialogue on this complex and important area. We are mindful, however, that our technical knowledge and practical experience do not translate into superior insight on fundamental policy choices or macroeconomic analysis. Accordingly, we expect that any contribution we may make to discussions of fundamental reform will be responsive to initiatives that come from Treasury or Congress, and will be focused principally on practical and technical concerns that should be considered if fundamental reform is to be implemented.

We offer this report as a "down payment' on what we hope will be a substantial contribution to efforts to simplify the U.S. income tax system. As indicated below, we expect to produce follow-up reports on some of the topics we identify. In addition, we expect to consider simplification as we suggest topics for Treasury's business plan and as we respond to legislative and regulatory initiatives and requests for comment that emerge during the year.

II. An Overview of Complexity

"[T]ax simplification is not simple."[3] It is, in fact, sufficiently complex that the Staff of the Joint Committee on Taxation ("JCT Staff") devoted more than 1,000 thoughtful pages to the subject in a study published in April 2001.[4] Advocates of radical tax reform may of course take this as evidence that there is no solution but to "rip the Code out by the roots." We see no benefit in discussing that question at this time. Rather, we welcome the current interest in simplification, while acknowledging that the potential scope of the enterprise is daunting.

Before proceeding to specific suggestions, we offer a few thoughts on the varieties of tax complexity and the competing concerns that arise when

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[2] NYSBA Tax Section Report 1003, *Report on the Treasury's" Subpart F" Study*, January 10, 2002.

[3] This quotation is from the Overview of Tax Simplification that was issued in connection with the release by the Office of Management and Budget, *U.S. Budget for Fiscal Year 2003, Analytical Perspectives – Chapter 4 – Federal Receipts, Tax Simplification*, paragraph 111, 2002 TNT 24-14 (February 5, 2002).

[4] Staff of the Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986*, (JCS-3-01), April 2001 (hereinafter, "JCT Staff Report").

simplification is sought, either in remedying existing complexity or in evaluating new legislative or regulatory proposals.

A. Computational Complexity

Tax liability may be difficult to compute, even if the rules are clear. Computational complexity may arise, for instance, from (i) different rates for different types of income (e.g., capital and ordinary), (ii) multiple tax systems (e.g., regular and alternative minimum tax), (iii) phase-outs (e.g., of the personal exemption) and phase-ins (e.g., the taxable portion of social security benefits), and (iv) complex calculations for determining certain items of taxable income (e.g., original issue discount).

Computational complexity is most problematic when it results in errors, frustration, and the need for extensive assistance on the part of relatively unsophisticated taxpayers.[5] Computational complexity is also often costly to address, in terms of the revenue impact of simplification – the individual alternative minimum tax being the most obvious case in point. We believe that Congress and the executive branch are best qualified to deal with the revenue cost of remedying computational complexity. To say computational complexity is "too expensive" to fix is to treat it as a relatively low priority (and generally has an unstated premise that offsetting revenue losses by adjusting the rate or base structure is "off the table").

B. Compliance Complexity

Preparing and filing a tax return may be complicated even if the law is clear and easy to understand and liability easy (in theory) to compute.[6] The same is true of the Internal Revenue Service's responsibility to monitor compliance. Record keeping is one significant source of compliance complexity. For instance, individuals have difficulty keeping track of charitable contributions or of the basis of capital assets (including, for instance, dividend reinvestments in mutual funds for the entire holding period). Businesses also may find it complicated to maintain tax records that differ from the records they maintain for financial reporting or other purposes.

Compliance complexity is not just a source of frustration for taxpayers; it is also a source of noncompliance (ranging from corner cutting to outright

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[5] Although widespread computer use may eventually ameliorate the problem of computational complexity, this report does not assume that an individual taxpayer has access to a computer and software to compute his or her tax liability.

[6] "Computational complexity" and "compliance complexity" are referred to together as "compliance complexity" in the academic literature. See David Bradford, Untangling the Income Tax 266-67 (1986). See also Deborah L. Paul, "The Sources of Tax Complexity: How Much Simplicity Can Fundamental Tax Reform Achieve?" 76 N.C. Law Rev. 151 (1997).

cheating) that poses an administrative problem for the Internal Revenue Service ("IRS"). Thus, resolving issues of compliance complexity by relaxing record-keeping requirements may address taxpayer frustration but exacerbate noncompliance.

This issue is worth bearing in mind during the current legislative cycle as Congress considers allowing non-itemizers a limited deduction for charitable donations. The honest taxpayer who makes a weekly cash contribution to the church collection plate will feel rightly entitled to the deduction. It is true, of course, that taxpayers bear the burden of proof on deductions. However, auditing the charitable deductions of non-itemizers is likely to engender ill will (from honest taxpayers whose deductions are disallowed for lack of substantiation) while occurring with insufficient frequency to serve as a practical deterrent to those claiming the deduction improperly. Although this concern is not itself dispositive of the merits of the legislative proposal, it should be balanced against the intended policy objectives.

In some cases, adding to taxpayers' compliance burdens may be the only effective way of combating abuse. Thus, we have supported increasing penalties for nondisclosure as one method to combat tax shelters. Increased disclosure by sophisticated taxpayers and promoters of transactions that have tax reduction as a significant purpose is justified if it increases the ability of the IRS to detect and combat abusive tax shelters. The keys to success are timely, focused disclosure and rigorous monitoring and enforcement by the IRS. The jury is not yet in on the effectiveness of the current regime, parts of which are only in proposed form (e.g. the revisions to Circular 230 addressing tax shelter opinions). Certainly, the area is one that will merit close monitoring by Treasury and Congress for the foreseeable future.

C. Technical Complexity

A particular rule may be difficult to find, difficult to understand, or difficult to apply because of poor drafting, poor organization, the sheer volume of intricate rules, redundancies, deadwood, or inadequate cross-references. For example, the wording of section 341, governing collapsible corporations, is notoriously complex; section 382 and the section 382 consolidated return rules are time-consuming to read and complicated to apply; and the various attribution rules are scattered throughout the Code.[7] In some cases, the governing law does not even appear in the Code (e.g., Section 530 of the Revenue Act of 1978, pertaining to classification of workers as employees or independent contractors).

[7] All section references are to the Internal Revenue Code, as amended, and the regulations promulgated thereunder.

It may be possible to reduce technical complexity without increasing other types of complexity or affecting substantive tax policies. [8] For example, as explained later in this report, section 341 could be repealed without significant policy cost because the concerns that motivated its enactment are largely moot. Simplification of section 382 is also an attractive goal, but one that involves weighing of valid policy concerns.

As discussed further below, achieving simplification of the attribution rules, while desirable, is not as simple as it sounds. Consolidating the attribution rules would definitely be worthwhile if the Code were being redrafted from scratch. However, the scope of that project in the context of an existing Code raises the issue of prioritization, given the competing and arguably better uses of time for those involved in drafting tax legislation. Thus, it is unclear to us that wholesale rewriting of the attribution rules is the best way to proceed, as opposed to a more targeted focus on particular areas of uncertainty or inconsistency. The calculus of how much to change also will be affected if potential simplification is thought to require complicated grandfathering rules.

Writing rules to address the general rather than the specific is another way to reduce technical complexity, but this approach tends to increase ambiguities, uncertainty and "interpretational complexity."

D. Interpretational Complexity

The tax laws may be difficult to interpret and apply to specific situations. For example, it may be unclear whether an individual is an employee or an independent contractor, or whether a financial instrument is debt or equity. Interpretational complexity can arise from poorly drafted laws and regulations, from conflicting provisions, or from rules that address the general but not the specific (e.g., broad "anti-abuse rules").[9]

A classic conflict exists between interpretational complexity that arises from general rules that may be difficult to apply in specific circumstances (e.g., the "partnership anti-abuse rules"), and technical complexity that arises from highly detailed rules (such as the section 704 regulations and the section 382 rules). Some balancing is necessary, and it is rarely perfect. For example, the history of section 367 illustrates an evolution from general principles (and interpretationally complex rules that were difficult to apply) to highly detailed

[8] Academics sometimes refer to "technical complexity" as including "interpretational complexity," which is discussed below. See Edward J. McCaffery, "The Holy Grail of Tax Simplification," 1990 Wis. L. Rev. 1267, 1270-72.

[9] "Technical complexity" and "interpretational complexity" together create the "rule complexity" referred to in the academic literature. See David Bradford, Untangling the Income Tax 266-67 (1986). The JCT Staff refers to these complexities collectively as "drafting complexity." See JCT Staff Report, vol. I, at p. 43.

rules that present technical complexity because they are complicated and difficult to parse. Reducing interpretational complexity without creating technical complexity is one of the most difficult challenges for the tax law.

E. Transactional Complexity

Even tax laws that are easy to read, understand and apply may lead to complicated transactional structures, financial products, and tax planning, or difficult decisions. This is because the substantive tax law often treats economically similar arrangements very differently, or offers many choices with varying tax consequences. For example, complicated multinational corporate restructurings, derivatives engineering, and tax-free acquisitions all involve significant transactional complexity. Taxpayers are also provided a myriad of elections scattered throughout the Internal Revenue Code. While as a policy matter each of these choices may be justifiable, overall they tend to contribute to planning and administrative complexity. For instance, individual taxpayers are offered such a bewildering number of tax-advantaged savings and retirement options that they may need professional assistance to choose intelligently.

Reducing transactional complexity may require major substantive revision that affects other tax policies and revenue. For example, taxpayers' efforts to stay outside the scope of the straddle rules, the constructive sale and constructive ownership rules, and the wash sale rules all give rise to substantial transactional complexity. The policy basis for these complex regimes is that they limit inappropriate manipulation of our realization-based system. A mark-to-market tax system might reduce transactional complexity and the need for all of these anti-abuse regimes, but might also increase other types of complexity (e.g., line drawing between types of property that are marked to market and types that are not; valuation of derivatives; transition issues).

F. Complexity Arising from Frequent Changes in Law

Frequent changes in the tax law are another source of complexity – something to bear in mind when changing the law to produce simplification. Unlearning old rules and learning new ones are not easy and may lead to errors and frustration on the part of the sophisticated and unsophisticated alike. In addition, change in law often brings complicated grandfathering regimes and transactional complexity as taxpayers plan for or react to the changes. For instance, whatever one's views on the subject of repealing the estate tax, it must be acknowledged that the regime enacted in 2001, which provides for a phase-out of the estate tax followed by its scheduled reintroduction in 2011, is producing enormous transactional complexity as it now stands. Likewise, whatever the merits of targeted tax credits as a way of producing stimulus or promoting other policy goals, they certainly add to the complexity of the Code.

III. Suggestions for Simplification

Below are brief descriptions of a few areas that we believe are ripe for simplification. As indicated above, the list is not intended to be comprehensive. Thus, the fact that we have not commented on most of the simplification proposals put forward in the JCT Staff Report is in no way a comment on their merits.

A. Individual Income Tax

In the individual income tax area, we recommend focusing on changes that reduce computational and compliance complexity.

1. Individual Alternative Minimum Tax

Current Law. Determination of whether an individual is taxable under the alternative minimum tax ("AMT") regime, and if so, how much is owed, requires complex computations in which regular taxable income is adjusted by adding certain items and disallowing or reducing certain deductions. Among the amounts added to an individual's income for purposes of calculating AMT are income with respect to the exercise of qualified incentive stock options, tax-exempt interest on certain private activity bonds, and a portion of the amount excluded from income under section 1202 with respect to gain on the disposition of certain small business stock. Among the deductions disallowed in computing an individual's AMT liability are miscellaneous itemized deductions, deductions for state and local taxes, standard deductions, personal exemptions, and certain deductions for home mortgage interest.

Discussion. The individual, like the corporate, AMT was enacted with the policy goal of requiring taxpayers with substantial realized economic income to pay some tax. We do not challenge the initial legitimacy of this policy choice. We believe, however, that the need for an overall backstop to the individual income tax is far less compelling after enactment of the passive activity loss rules of section 469 and the limitation on individual deductions imposed by the "at risk" rules of section 465. Indeed, were there no individual AMT in place today, the suggestion to enact this regime would be little short of ludicrous, in view of the computational and compliance complexity it entails. Moreover, the situation is projected to become more and more unacceptable, as increasing numbers of middle-income taxpayers find themselves subject to the AMT. [10] The only argument against repeal is the revenue cost.

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[10] See, e.g., Office of Management and Budget, *U.S. Budget for Fiscal Year 2003, Analytical Perspectives – Chapter 4 – Federal Receipts, Tax Simplification*, paragraph 118, 2002 TNT 24-14 (February 4, 2002) explaining the impact of the increased individual AMT:

(…continued)

The revenue cost of repealing the individual AMT was substantially increased by the scheduled tax rate reductions enacted in 2001, which greatly expanded the number of taxpayers expected to become subject to the AMT. If there had been less reduction of the top marginal rate, it would be much easier to repeal the individual AMT. Thus, the decision recently made to schedule reductions in the top marginal rate, with the attendant increase in computational and compliance complexity for millions of taxpayers, was at the expense of simplification.

The question at present is when and how to address this increasing (and increasingly unacceptable) complexity. One possible answer, though not the only one, would be to pay for the cost of repealing the individual AMT by revisiting the scheduled reductions in the top marginal rate. It may be argued, of course, that this is bad policy, or bad politics, or both. We do not view ourselves as having any expertise on the "right" rate schedule for taxes, and we acknowledge that Congress might choose to deal with the revenue implications of repealing the individual AMT in some manner other than adjustments to the rate schedule. To say, however, that repeal of the individual AMT is "too expensive" is to make a judgment that simplification is less important than maintaining the status quo in terms of the rate schedule and forgoing other potential sources of revenue offset. Practically, this amounts to treating one of the most problematic areas of complexity in the Code as a relatively low priority. Partial solutions are possible, of course – again, it is a question of priorities.

We note that, at the margins, repeal of the individual AMT might lead Congress to consider other means of regulating some of the items that are currently subject to adjustment under the AMT regime. For instance, if Congress is concerned about limiting the benefit an individual can derive from holding tax-exempt private activity bonds or selling certain small business stock, it can make changes to the Code sections providing such benefits. Any such changes would

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> "The number of taxpayers affected by the AMT and the amount of revenue raised by the AMT are rising rapidly, making simplification of the AMT an increasingly important objective of tax policy. This year, 2 million individual filers will be subject to the AMT and therefore required to file the 65-line AMT form. The temporary increase in the AMT exemption under EGTRRA will reduce the increase in the number of AMT taxpayers through 2004. Nevertheless, that number will increase to 5 million in 2004, and more than double, increasing to 12 million in 2005 when the temporary provision expires. In 2005, 47 percent of taxpayers with AGI between $100,000 and $200,000 (in 2002 dollars) and 75 percent of taxpayers with AGI between $200,000 and $500,000 (in 2002 dollars) will pay AMT. By 2010, these percentages will increase to 90 percent and 96 percent, respectively. By 2012, the number of AMT taxpayers will be 39 million (assuming EGTRRA is extended), which is 34 percent of all taxpayers with individual income tax liability."

be unlikely to provide significant revenues, however, and should be evaluated on a policy basis (including concerns about adding undue complexity to the Code provisions in question).

2. Overall Limitation on Itemized Deductions and Phase-out of Personal Exemption and Other Items

Current Law. Section 68 of the Code reduces the overall allowable amount of itemized deductions of an individual taxpayer with income over a specified, inflation-adjusted threshold (currently $137,300 for single taxpayers and married taxpayers filing joint returns). The overall reduction is equal to the lesser of (i) 3 percent of the taxpayer's adjusted gross income over the threshold, or (ii) 80 percent of the otherwise allowable itemized deduction.

Section 151 provides for a "personal exemption" deduction (currently $3,000) that is phased out with reference to the amount by which the taxpayer's income exceeds a threshold amount (currently $137,300 for single taxpayers).

Numerous other provisions of the Code allow individual taxpayers deductions, credits, or exemptions that are phased out for taxpayers with income above varying thresholds. For instance, the child credit allowed by section 24 of the Code (currently $600 per child) is phased out for taxpayers with income above a threshold that is currently $110,000 for joint filers. Taxpayers can be subject to more than one phase-in or phase-out at the same time. One consequence is that incremental increases in income above the varying thresholds can be taxed at rates well above the top marginal rate.

Discussion. The JCT Staff recommends that the overall limitation on itemized deductions and the phase-out of personal exemptions be eliminated.[11] In addition, the JCT Staff recommends that the following be eliminated: (i) phase-out of child credit; (ii) partial phase-out of the dependent care credit; (iii) phase-outs relating to individual retirement arrangements; (iv) phase-out of the HOPE and Lifetime Learning credits; (v) phase-out of the deduction for student loan interest; (vi) phase-out of the exclusion for interest on education savings bonds; and (vii) phase-out of the adoption credit and exclusion.[12]

The main arguments for eliminating the overall limitation on itemized deductions and the various phase-outs is that they require taxpayers to understand complicated rules and make complex calculations to determine the amount of an allowable tax benefit, increasing the cost and time required to prepare a tax return, the costs and resources of the IRS devoted to enforcement of these provisions, and the probability of computational and substantive errors by taxpayers. Because of

[11] JCT Staff Report, vol. II, pp. 79-91.

[12] *Id.*

the complexity of these calculations and the substantive rules relating to these tax benefits, taxpayers with incomes near the relevant threshold levels may fail to claim benefits to which they are entitled, may inadvertently take actions that eliminate their tax benefits, and may have difficulty predicting their incomes for purposes of tax planning or complying with the estimated tax rules. Overall, the complexity of the phase-out rules may contribute to the relatively widespread perception that the tax system is unduly burdensome and arguably unfair. According to the JCT Staff, its recommendations would provide simplification for up to 30 million returns that are subject to one or more of the present law phase-outs.[13]

The issue to be considered is whether implementing the recommendations of the JCT Staff would frustrate a discernible policy. In the case of the overall limitation on itemized deductions and the phase-out of the personal exemption, the policy, insofar as we can discern it, seems to be a preference for a lower top marginal rate even if the cost is substantial complexity. We believe repeal is justified, if simplification is indeed a high priority. As with the individual AMT, we believe it is for Congress to determine how best to deal with the revenue implications of repeal.

In other cases, there may be more room for discussion as to the appropriateness of a phase-out. To take the clearest case, no one would seriously doubt that if there is to be an earned income tax credit, it must be phased out (although there may well be room for simplifying the calculation). The child credit is a less clear case. If one views the policy of the credit to be tax relief for low- and middle-income taxpayers with children, on the theory that this will improve the ability of such families to provide appropriately for their children, then phasing out the credit is perhaps reasonable, though complicated. On the other hand, one might argue for repeal on either of two grounds: (i) that the policy of the credit is to subsidize modestly the economic burden of raising children, which is borne even by upper-income taxpayers, or (ii) that whatever the policy may be, the complexity associated with the phase-out is not worth the candle, and the revenue implications are better addressed in other ways.

3. Individual Capital Gains and Losses

Current Law. Under current law, capital gain income is divided into ten different categories and may be subject to any of at least seventeen different rates of tax. Determining and reporting the rate of tax and liability for capital gains are computationally complex and apparently lead to a substantial number of errors.

Discussion. We agree that the proposal by the JCT Staff to replace the current regime with a deduction equal to a fixed percentage of a taxpayer's net

[13] *Id.* at 87.

capital gain would significantly simplify an individual's computations and return preparation.

The degree to which a deduction regime would achieve simplification would depend in part on whether Congress considered it desirable to preserve the proportionality of the benefits currently available for different classes of capital gain. If so, it would presumably be necessary to vary the percentage excluded from income (as between collectibles, for instance, "regular" long-term capital gain, and five-year capital gain). In that case, notwithstanding substantial computational simplification, the regime would remain somewhat complicated from a computational and compliance perspective.

Additionally, we observe that the JCT's proposal would have complicating consequences for a number of states and municipalities that base their tax on federal adjusted gross income or federal taxable income. These jurisdictions would either have to absorb revenue loses or enact "add-back" legislation to protect their tax bases.

B. Passive Foreign Investment Companies

Current Law. The Code generally defines a passive foreign investment company ("PFIC") as a foreign corporation that, in any year, runs afoul of either an income test or an assets test. A foreign corporation will be a PFIC in any year that 75% or more of its gross income is "passive' income as defined in the PFIC rules – including interest, dividends, certain rents and royalties and gains from the sale of property that gives rise to any of the foregoing. A foreign corporation will also be a PFIC in any year that 50% or more of its assets, by value, produce or are held to produce passive income. Unless a U.S. shareholder of a PFIC makes a valid and timely "QEF" election – which may in some cases be difficult or even impossible – the U.S. shareholder becomes subject thereafter to a fairly draconian regime intended to discourage U.S. portfolio investment in foreign passive investment vehicles.

Discussion

The current PFIC regime causes a great deal of transactional and compliance complexity. As noted in a prior report of the Tax Section,[14] the PFIC provisions are overly broad, reaching well beyond the understandable policy concern that motivated their enactment. As a result, far more taxpayers currently have to wrestle with these rules than is justified on the basis of sound policy concerns. The complexity of the PFIC rules may be warranted in those cases where the foreign corporation in question is operating in a manner similar to a mutual fund or passive investment company. However, the PFIC rules are so

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[14] NYSBA Tax Section Report 994, *Report on Proposals for Guidance with Respect to Passive Foreign Investment Companies,* May 22, 2001.

broad that they can and often do appear to apply even to publicly traded foreign operating corporations, particularly those (like emerging technology companies) that have little in the way of tangible assets and current revenues. The resulting complexity and uncertainty create needless barriers to non-tax-motivated transactions. Although there would be complexities in implementing some of the recommendations in our PFIC report, we believe that overall our recommendations would appropriately reduce the overbreadth of the PFIC regime, thereby reducing compliance and transactional complexity, without violating the fundamental policies motivating the regime.

We would be pleased to comment on any legislative proposal to accomplish such results.

C. Overlapping International Anti-Deferral Rules

Current Law. The Code contains five separate anti-deferral regimes affecting international taxation, exclusive of the accumulated earnings tax. These are: (1) the subpart F rules of section 951 to 964, applicable to controlled foreign corporations ("CFCs"); (2) the passive foreign investment company ("PFIC") rules of sections 1291-1298; (3) the personal holding company ("PHC") rules at sections 541-547; (4) the foreign personal holding company ("FPHC") rules at sections 551-558; and (5) special rules applicable to foreign investment companies ("FICs") in sections 1246 and 1247. In general, each set of anti-deferral rules is designed to prevent the excessive deferral and accumulation of income by U.S. taxpayers through the use of foreign corporations, the foreign income of which is not currently subject to U.S. tax.[15]

Each regime becomes applicable at different levels of U.S. ownership, taking into account different sets of constructive ownership rules. Although each regime affects primarily "passive" income, the definition of passive income varies from section to section. There is significant overlap of the five regimes, usually addressed by provisions that give precedence to one regime over another.

Discussion. We recommend that the current five regimes applicable to foreign corporations be collapsed and streamlined into two. One surviving set of rules would apply to foreign corporations that are controlled by U.S. persons. Subpart F would be the model for this regime; the FPHC rules would be folded into subpart F and repealed, and the PHC rules would be made inapplicable to foreign corporations. The second set of rules would apply to portfolio ownership and would be modeled upon the PFIC rules; the FIC rules would be repealed. We believe these changes will provide substantial simplification without significantly affecting any policies or revenue.

[15] The PHC rules also apply to U.S corporations. We do not propose a change to that aspect of the PHC rules.

Each of the five regimes itself presents extraordinary technical, interpretational, transactional and compliance complexity. While a degree of complexity is unavoidable in the context of cross-border taxation, there is no compelling policy or revenue justification for five sets of rules when fewer would suffice. The CFC rules of subpart F already incorporate most of the PHC/FPHC rules. Therefore, it should be possible to limit the PHC rules to wholly domestic corporations and to repeal the FPHC rules. In a similar vein, the relatively ancient FIC rules, which are in any event of limited application, could be repealed in favor of the newer (and simplified, if our proposals are adopted) PFIC regime.

We are prepared to submit a report responding to any request for comment on issues identified in the course of drafting such legislation.

D. Corporate Income Tax

1. Collapsible Corporations

The collapsible corporation rules are an example of a complex regime that has largely outlived its usefulness.

Current Law. Under section 341, gain on the sale or liquidation of a collapsible corporation is treated as ordinary income. A "collapsible corporation" is a corporation formed principally for the construction or production of property, the purchase of certain types of assets, or to hold stock in such a corporation, with a view to (1) the sale of the stock by the shareholders or a distribution to the shareholders prior to the realization by the corporation of two-thirds of the taxable income to be derived from the property, and (2) the realization by the shareholders of the gain attributable to the property. The ordinary income rule does not apply if (i) the taxpayer does not own more than 5% in value of the outstanding stock, (ii) not more than 70% of the gain is attributable to the property, (iii) the taxpayer realizes gain more than 3 years after the corporation completes production or purchase of the property, (iv) the taxpayer meets certain requirements as to the net unrealized appreciation on certain assets, or (v) the corporation consents to recognize gain on the disposition of certain of its assets.

Prior to the repeal of the *General Utilities* doctrine, a taxpayer who constructed or produced property – for example, houses – could convert what would otherwise be ordinary income into capital gains by, instead of simply constructing houses and selling them, creating a corporation to construct a particular property or set of properties. The corporation would construct the property and then, rather than selling the property directly, distribute the property out to its shareholders. These shareholders would thus have capital gain income, instead of the ordinary income the corporation would have realized on the sale of the property. Because of the *General Utilities* doctrine, the corporation would recognize no gain on the distribution of the appreciated property. The collapsible corporation provisions were enacted to prevent this manipulation of the corporate form.

The application of the collapsible corporation provisions was limited by amendments enacted in 1958 and 1964. Section 341(e) is intended to prevent ordinary income treatment from being applied to taxpayers who would have been eligible for capital gains treatment even if they had held the property directly, rather than through corporate form. Section 341(f) was enacted to prevent 341 from applying in situations in which the corporation was going to continue in existence and recognize the income from the property in due course.

Discussion. The collapsible corporation provisions are no longer necessary to prevent the abuse at which they were principally aimed, because corporations are now required to recognize income on the distribution of appreciated property. Yet the provisions remain in the Code as a trap for the unwary. Repeal of section 341 would seem appropriate.

We recognize that repeal of section 341 would potentially allow an inventor or homebuilder, who might have ordinary income on the sale of what he or she produced, to realize capital gain by placing the property in a corporation and selling the stock. However, if this were done in connection with a sale, the attempted tax-free incorporation should be treated as a taxable event under the step transaction principles, triggering ordinary income. Also, the consequences of placing low-basis property in a corporation is generally unattractive to buyers,[16] reducing the likelihood of a substantial amount of such activity. On balance, we believe that the policy concern is sufficiently attenuated that the simplification achieved by repeal is the better course.

2. Active Business Requirement of Section 355

The manner in which the "active business" requirements of section 355 are applied to holding companies produces transactional complexity that serves no notable policy purpose.

Current Law. Section 355 allows a corporation to distribute to its shareholders or securityholders stock or securities of a controlled corporation if the distribution meets certain requirements. These requirements include that the distributing corporation distribute an amount of stock constituting control of the distributed corporation and that "(A) the distributing corporation, and the controlled corporation . . . [each] is engaged immediately after the distribution in the active conduct of a trade or business, or (B) immediately before the distribution, the distributing corporation had no assets other than stock or securities in the controlled corporations and each of the controlled corporations is

[16] For instance, a corporate buyer of an invention would get no step-up in basis of the property being acquired, which might otherwise have been amortizable and, in any event, would be subject to corporate-level tax if the property were subsequently sold. An individual buyer of a corporation owning a home would suffer a number of tax detriments (e.g., imputation of a charge for rent that would be non-deductible to the payor and taxable income to the corporation).

engaged immediately after the distribution in the active conduct of a trade or business."

To qualify as being engaged in the active conduct of a trade or business, the corporation must, throughout the five years prior to the distribution, be "engaged in the active conduct of a trade or business, or substantially all of its assets consist of stock and securities of a corporation controlled by it (immediately after the distribution) which is so engaged." The IRS has accepted that a corporation is engaged in the active conduct of a trade or business when as little as 5% of the total fair market value of the gross assets of the corporation are used in the trade or business.[17] However, when the corporation merely has control of a corporation engaged in the active conduct of a trade or business, the IRS has required that 90% of the corporation's gross assets consist of stock or securities of such a controlled corporation.[18] The active trade or business requirement prevents a corporation's using a section 355 distribution to split passive investment-type assets from active business assets so that shareholders may sell off the investment-type assets separately.

Discussion. We are on record as supporting legislation providing that the active business requirement of section 355 be applied on an affiliated group basis.[19] The distributing group would include the distributing corporation as the common parent and all corporations affiliated with the distributing corporation through stock ownership described in section 1504(a)(1)(B), without regard to the exceptions contained in section 1504(b) (e.g., foreign corporations). The controlled corporation group would be defined analogously, with the controlled corporation as the common parent.

The current "substantially all assets" test forces an affiliated group of corporations that use a holding company structure to undergo sometimes elaborate restructuring to meet the active business requirement of section 355. This restructuring may not include any shift in the overall ownership of active business assets or investment-type assets, but simply a rearranging of the assets within the affiliated group. It is unclear how this shifting serves the purpose of the section 355 active business requirement. If the active business status of the distributing and controlled corporations were judged on an affiliated basis, each group would still contain an active business, thus preventing the ability of shareholders to sell investment-type assets separately.

[17] Rev. Proc. 99-3, 1999-1 I.R.B. 111.

[18] Rev. Proc. 86-41, 1986-2 C.B. 716; Rev. Proc. 77-37, 1977-2 C.B. 568.

[19] Letter dated January 12, 1999, in support of S. 2358, introduced by Sen. John B. Breaux, D-La. Please see this letter for additional suggestions regarding section 355.

E. REMICs/FASITs

Current Law. The FASIT rules were enacted in 1996 to extend the benefits of the REMIC regime (in particular automatic debt treatment of equity interests having the economic features of debt) to securitizations involving non-mortgage assets and revolving pools.

Discussion. We believe it likely that significant simplification could be achieved by repealing the FASIT rules (sections 860H-860L) and replacing them with a series of limited changes in regulations and possibly in the REMIC rules.

In our experience, the FASIT legislation is not being used by those who would be expected to benefit from it and it is unlikely that situation will change. The reasons are twofold: (1) technical problems with the legislation and (2) the requirement that gain be recognized upon the transfer or deemed transfer of assets to a FASIT (in some cases measured based on inflated values). It is possible that some of the most significant technical problems could be resolved through the adoption of comprehensive and reasonable regulations. The IRS issued proposed regulations addressing some issues under the FASIT rules in 2001. The Tax Section submitted a report that was highly critical of the proposed regulations.[20] Apparently, the IRS has no current plans to finalize the regulations – the project was not included in the "business plan" for the period ending June 2002 (either as a project to be completed during the plan year or as a project to which substantial resources will be committed during that year). We believe that revising and expanding the regulations to cure the technical deficiencies in the statute would be a major project for the IRS. Even if the regulations were fixed and finalized, the gain recognition rule (plus some difficulties in making a FASIT election for existing master trusts) very likely would prevent FASITs from being widely used, at least outside of the mortgage area.

Under the circumstances, we believe that government resources would be put to better use if the FASIT statute were repealed and some or all of the specific problems at which it was aimed were addressed through narrowly tailored changes in regulations and possibly in the REMIC rules. Commentators have recently submitted a letter to the Treasury outlining a package of changes that would serve to replace the FASIT rules.[21] We have not reviewed those proposals in detail and accordingly are not in a position to comment on them at this time. We believe, however, that the basic approach of coupling a repeal of the FASIT rules with a package of narrowly tailored changes is well worth considering as a simplification measure. We intend to produce a report on this topic later this year.

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[20] NYSBA Tax Section Report 973, *Report on Proposed Regulations Relating to Financial Asset Securitization Investment Trusts*, May 5, 2000.

[21] See letter from James M. Peaslee and David Z. Nirenberg to Mark A. Weinberger, June 6, 2001 reproduced at 91 Tax Notes 2079 (June 18, 2001).

F. Section 514(c)(9) – The Fractions Rule

Current Law. Under section 512, tax-exempt organizations generally are taxable on their "unrelated business taxable income" ("UBTI"). UBTI generally includes a portion of any income derived from an investment as to which a tax-exempt organization incurs "acquisition indebtedness" within the meaning of section 514. However, under section 514(c)(9), real estate investments subject to acquisition indebtedness that are made by pension funds, endowment funds and certain other types of tax-exempt organizations are not treated as giving rise to UBTI if the investment satisfies six requirements.

One of the section 514(c)(9) requirements, usually referred to as the "fractions rule", applies in situations where the investment is held through a partnership that includes any taxable investor. The fractions rule imposes very rigid mechanical requirements on the allocations of income and loss by the partnership so as to prevent taxable investors from being allocated a disproportionately large share of partnership loss.

Section 514(c)(9) and the fractions rule in particular represent extreme technical complexity, which in turn gives rise to transactional complexity as partnerships attempt to comply with it.

Discussion. We recommend that section 514(c)(9) be amended to eliminate the fractions rule and instead substitute a tax avoidance test. Under that test, a partnership's tax allocations would satisfy section 514(c)(9) if its allocations are not made with a principal purpose of tax avoidance. This test is similar to the test that was in effect prior to the enactment of the fractions rule in 1986, but with the test being "a" principal purpose rather than "the" principal purpose test in effect under pre-1986 law. We have recommended this revised test before.[22]

While we accept the policy underlying section 514(c)(9), we believe that the fractions rule is deeply flawed. To briefly summarize, the fractions rule presents two major problems.

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[22] See NYSBA Tax Section Report 894, *Report on Section 514(c)(9)(E) Concerning Investments in Leveraged Real Estate Partnerships by Pension Trusts and Other Qualified Organizations*, February 14, 1997 for a more detailed description of the problem and recommendation. In particular, the report recommends that the new test under Section 514(c)(9)(E) should be a two-part test requiring that each partnership allocation have substantial economic effect (as under current law) and that no allocation have a principal purpose of tax avoidance. The report also discusses remedies for the "cliff problem" (the all-or-nothing penalties under current law) and for alternative, piecemeal approaches to modifying section 514.

The first is that the fractions rule is extremely difficult to understand in principle and apply in practice. While the statutory language is deceptively simple, the regulations promulgated thereunder are technically complicated: they are extremely detailed and cannot be fully understood without a broad understanding of Subchapter K. Moreover, the regulations necessitate that every allocation that might possibly be made over the life of the partnership be analyzed to determine whether the regulation might ever be violated.

The second problem is that the rigid mechanical requirements of the fractions rule effectively prevent a variety of perfectly reasonable, non-tax motivated business arrangements in real estate partnerships. Examples of such arrangements include general partner carried interest "clawback" provisions and special allocations of expenses to a partner that funds such expenses. It is doubtful that the full business implications of the fractions rule were ever contemplated by Congress.

The proposed approach would avoid such problems by moving from a rigid mechanical approach to a subjective one that simply looks at whether a partnership's tax allocations have a tax avoidance purpose. We recognize that a similar subjective approach was abandoned in 1986, but we believe that the current rule does not strike the best balance and in any event we are suggesting a much broader tax avoidance test with the use of an "a" principal purpose standard. We also acknowledge that while our recommendation will reduce technical complexity, it may give rise to some additional interpretational complexity as taxpayers grapple with the subjective test. Nevertheless, on whole we believe that our recommendation will strike a better balance.[23]

G. Attribution and Related-Party Rules

Current Law. The Code has a large number of rules that classify one or more persons or entities as related, or as owning another's property. These rules are used to treat transactions between related parties differently than those between unrelated parties (e.g., sections 267 and 707), or otherwise to affect the tax treatment of a transaction (e.g., application of the straddle rules on the basis of a position held by a related party) or to determine the tax status of an entity (e.g., a controlled foreign corporation). The Code contains not one, but several basic sets of attribution rules (sections 267, 318, 544, 554, 958, 1297 and 1563). Many other Code sections and regulations incorporate attribution or related-party concepts, often with modifications from the basic regimes. The results can be counterintuitive, and the distinctions between different regimes sometimes seem illogical (as in the differing definitions of "family" discussed below). The result is substantial technical complexity and, on occasion, interpretational and transactional complexity.

[23] If our recommendation is accepted, it would be possible to flesh out the rule by regulations illustrating impermissible and permissible arrangements.

By way of illustration, there are a number of provisions that define a "family" for purposes of attributing stock ownership. Section 267, which disallows losses on sales or exchanges between related taxpayers defines "family" as "brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants." Section 544, which provides rules for determining stock ownership for the purpose of determining whether a corporation is a personal holding company, and section 554, which provides analogous rules for foreign personal holding companies, use the same definition. Section 318 , which provides the constructive ownership rules for numerous sections, defines a taxpayer's family as "(i) his spouse (other than a spouse who is legally separated from the individual under a decree of divorce or separate maintenance), and (ii) his children, grandchildren, and parents." Section 318 also specifies that a legally adopted child shall be treated as a child by blood. Section 1563, which defines a controlled group of corporations, includes rules that require attribution in certain circumstances to a taxpayer's "spouse (other than a spouse who is legally separated from the individual under a decree of divorce whether interlocutory or final, or a decree of separate maintenance)," children, parents, grandchildren and grandparents. Section 1563 also directs that adopted children are to be treated as children by blood.

There are several areas of variation in these definitions. First, some of the definitions include siblings, while others do not. Second, several of the provisions do not address the status of adopted children. Third, only section 1563 specifies that an interlocutory decree of divorce will break familial stock attribution. Finally, several of the provisions specify that attribution only extends up and down two steps (to grandchildren and grandparents), while others refer to all ancestors and descendants.

Discussion. One approach to dealing with the technical complexity of the various attribution regimes would be to aim for a more consolidated and uniform set of rules. This would seem the most logical approach if the Code were being rewritten from scratch. It is not, however, and we question whether there are not better uses of time than undertaking such a massive effort. That said, we are willing to comment on any such effort that the Treasury or Congress sees fit to undertake.

A less radical approach to dealing with the attribution rules would be to identify those issues which seem most problematic and address them on a case-by-case basis. For instance, a uniform definition of family would be easier for taxpayers and their attorneys to apply. In addition, creating a single definition would allow for the modernization of the rules.

It is unclear why siblings were not included in the section 318 definition of family. It is conceivable that it was believed that a number of the situations in which the section 318 definition is applicable – such as redemptions of stock – could involve siblings who wished to split up a business because they believed their interests to be adverse. It is possible, of course, that the same situation may occur between parents and children, but it may be more common between siblings (because the parent is more likely to be in control of the corporation, while siblings may be sharing control), and this may be a reason to exclude siblings from the section 318 definition in particular. However, aside from this possible reason – which applies only to a few of the rules governed by the section 318 definition – there seems no other reason to include siblings in the other family provisions but not in section 318.

There appears to be no policy justification for the varying provisions involving adopted children, divorce and the extent of attribution to descendants and ancestors. Treating legally adopted children in the same manner as blood children is consistent with the general trend in the law. Clarifying the treatment of interlocutory divorce decrees will provide certainty for taxpayers. There is no clear reason not to include great-grandparents and great-grandchildren in attribution; therefore, including all ancestors and lineal descendants, rather than only grandparents and grandchildren, makes sense.

Current section 1563 includes restrictions of stock attribution among family members to prevent the denial of the graduated corporate tax rates to truly separate businesses run by spouses and to limit attribution between parents and non-minor children. These provisions do reflect a clear policy choice and therefore should not be changed in the name of simplification.

The easiest way to produce a uniform definition of a family would seem to be adding a definition in section 7701 and incorporating it by reference in other Code provisions, which could provide any modifications deemed necessary to preserve policy choices (e.g., the limitations on attribution in section 1563).

We note that arguments may be raised that changing attribution rules upsets existing expectations and should be accompanied by grandfathering. This would substantially undermine the intended simplification. If, for instance, changing section 318 by adding siblings to the definition of "family" were deemed unduly disruptive (a point on which we express no view), it might be preferable to provide an exclusion in section 318 of "siblings" from the uniform definition of "family" rather than to provide a grandfathering regime (unless it was merely a delayed effective date with a reasonably short term).[24]

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[24] Another example of a problematic attribution rule appears in sections 544(a)(2) and 554(a)(2), which provide, among other things, that an individual is treated as owning shares owned by or for his partner (for purposes of determining whether five or fewer individuals own more than 50%, by vote or value, of the shares of a corporation, potentially triggering application of the personal holding company rules, or the foreign personal holding company rules, or both). This rule would make sense if partnership were a reliable indicator of close collaboration; it makes no sense when applied to deem a limited partner in an investment partnership to own shares held in a completely different context by other limited partners. We suggest eliminating partner-to-partner attribution.

H. Individual Retirement Arrangements, Qualified Retirement Plans and Employee Benefits

We agree with the JCT Staff that provisions dealing with individual retirement arrangements ("IRAs"), qualified retirement plans and employee benefits are ripe for simplification. We also recognize that there is significant complexity in these areas as a result of the complex nature of today's workplace and of employers and employees being provided a great deal of choice in supplying and choosing benefits. Not surprisingly, then, simplification must be weighed against policy considerations. We have reviewed the recommendations contained in the JCT Staff Report and agree with many of them.[25] We are currently preparing a report commenting on these recommendations and providing some additional recommendations. We expect to submit this report this spring.

I. Tax-Exempt Bonds

The JCT Staff has identified a number of problem areas relating to tax-exempt bonds that might benefit from simplification measures.[26] For example, the rules governing private activity bonds are extremely complex and create significant technical, interpretive and compliance complexity for issuers. The arbitrage yield and arbitrage rebate rules are another example of undue complexity. On balance, we agree with the JCT Staff that a number of provisions dealing with tax-exempt bonds should be simplified, although we do not necessarily agree with all of the Staff's suggestions. We are currently preparing a simplification report on tax-exempt bonds which we plan to submit by the summer.

[25] JCT Staff Report, vol. II, pp. 149-228.

[26] JCT Staff Report, vol. II, pp. 516-530.