



NEW YORK STATE BAR ASSOCIATION

One Elk Street, Albany, New York 12207 • PH 518.463.3200 • www.nysba.org

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DIANA L. WOLLMAN

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125 Broad Street
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May 22, 2013

The Honorable Mark Mazur
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable William J. Wilkins
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Daniel I. Werfel
Acting Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: New York State Bar Association Tax Section Report on Proposed Regulations Section 1.1411-10

Dear Messrs. Mazur, Werfel and Wilkins:

I am pleased to submit the enclosed New York State Bar Association Tax Section Report. The Report discusses the proposed regulations addressing the treatment under Section 1411 of the Internal Revenue Code (the "Code") of income and gains derived from the ownership of stock in a foreign corporation that is a "controlled foreign corporation" (a "CFC") or a "passive foreign investment company" (a "PFIC") ("Proposed Regulations 1.1411-10").

Proposed Regulations 1.1411-10 is part of a larger package of proposed regulations issued under Section 1411 (the "1411 Reg Package"), and we commented on other aspects of the 1411 Reg Package in a separate report submitted last week. As we discussed in that report, the main focus of the 1411 Reg Package is determining *which* items of income and deduction are taken into account in computing a taxpayer's "net investment income" ("NI"), which is the income base to which the new 3.8% tax under Section 1411 applies.

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Mr. Mazur
Mr. Werfel
Mr. Wilkins
May 22, 2013
Page 2

Proposed Regulations 1.1411-10 is slightly different in that it focuses, in large part, on *when* income and gains derived by a taxpayer from ownership of CFC or PFIC stock is included in NII. Under the regular income tax rules in the Code (*i.e.*, Chapter 1 of Subtitle A of the Code), a stockholder of a CFC, or of a PFIC which is a “qualified electing fund” with respect to the stockholder (a “QEF”), generally must include in the stockholder’s gross income each year an amount that reflects all or a portion of the earnings and profits derived by the CFC or PFIC during that year, *as if* those amounts had been distributed to the stockholder, whether or not they are in fact distributed. In our Report these inclusions in Chapter 1 gross income are referred to as “Subpart F Inclusion” (in the case of CFCs) and “QEF Inclusions” (in the case of QEFs).

The reason that the Code requires Subpart F Inclusions and PFIC Inclusions is, generally, to prevent the stockholders from achieving deferral of the U.S. federal income taxation of a CFC or QEF’s earnings by having those earnings remain undistributed. These rules essentially treat the earnings as if they had been distributed to the stockholders (like a dividend would be) during the year in which they are derived by the CFC or QEF.

Proposed Regulations 1.1411-10 addresses *when* Subpart F Inclusions and QEF Inclusions are included in a stockholder’s NII. Proposed Regulations 1.1411-10 provides that Subpart F Inclusions and QEF Inclusions are *not* included in a stockholder’s NII in the same year they are included in the stockholder’s Chapter 1 gross income; instead, these income inclusions are included in a stockholder’s NII only in the year during which the related earnings are in fact distributed by CFC or QEF to the stockholder.

This approach to Subpart F Inclusions and QEF Inclusions creates a divergence between the treatment of those amounts for Chapter 1 regular income tax purposes and their treatment under Section 1411. In order to address the consequences of this divergence, a number of complicated additional special rules are needed in order to ensure that amounts of income and gain are neither duplicated nor unaccounted for in computing NII. Proposed Regulations 1.1411-10 sets out these rules clearly and comprehensively, even though the rules are very complicated. We commend the Treasury Department and Internal Revenue Service on Proposed Regulations 1.1411-10.

The reason why Proposed Regulations 1.1411-10 takes this approach to Subpart F Inclusions and QEF Inclusions is that the statutory definition of NII includes the word “dividends,” but does not specifically refer to Subpart F Inclusions and QEF Inclusions, and technically under the Code, these inclusions are not “dividends.” Thus, the Treasury Department and the Internal Revenue Service explain in the preamble to Proposed Regulations 1.1411-10 that they believe they may lack the authority to include Subpart F Inclusions and QEF Inclusions in NII.

Proposed Regulations 1.1411-10 do provide a taxpayer with the ability to avoid all this complexity by making an election under Prop. Reg. Section 1.1411-10(g) (referred to as a “G Election”) to include Subpart F Inclusions and QEF Inclusions in the taxpayer’s NII at the same time as they are included in the taxpayer’s Chapter 1 gross income.

We believe that the Treasury Department and the Internal Revenue Service *do have the authority* to treat Subpart F Inclusions and QEF Inclusions as currently includible in NII, as if these amounts were dividends. We lay out our reasoning in the Report in detail. We think the complexity of Proposed Regulations 1.1411-10 is avoidable and should be avoided.

The Report's primary recommendation therefore is as follows:

- We urge the Treasury Department and IRS to issue regulations under Section 1411 that treat Subpart F Inclusions and QEF Inclusions as *currently includible in NII* for all taxpayers. The proposed G Election rules would be eliminated. (Section V.)¹

In the event that this recommendation is not taken, we offer several recommendations on how the Proposed Regulations could be clarified or improved, including:

- The Proposed Regulations should include analogs to Sections 959(a) and (e) and 1293(c) of the Code to prevent the earnings and profits of CFCs and QEFs from being included in the NII of the CFC's or QEF's U.S. shareholders more than once. (Section IV.B.)
- The rules governing the making of untimely G Elections should follow closely the rules governing the making of untimely QEF elections, so that (i) relief under Reg. Section 301.9100 is not available, (ii) the three retroactive election methods available to a PFIC shareholder who wants to make a retroactive QEF election also apply with respect to retroactive G Elections, and (iii) the PFIC "cleansing elections" that permit a stockholder of a PFIC to remove the taint of pre-QEF years should be copied by permitting a stockholder to make a "cleansing" G Election under rules that mirror those governing a PFIC cleansing election. (Section IV.E.)
- S corporations and domestic partnerships should be permitted to make G Elections at the entity level that would bind their respective shareholders and direct and indirect partners with respect to income and gain derived from their investments in CFCs and QEFs. We believe that this would improve the administrability of the Proposed Regulations. Because an individual's G Election applies to all of the individual's interests in CFC and PFICs and cannot be revoked without the consent of the Internal Revenue Service, consideration should be given to including anti-abuse rules to prevent individuals from using S corporations and domestic partnerships to "cherry pick" which CFCs or PFICs will be subject to G Elections. (Section IV.F.1.)

The regulations should contain an example illustrating the operation of Section 751 of the Code (taking into account Section 1248 of the Code) when a partner sells an interest in a partnership that holds CFC stock because the results are so non-intuitive that the clarity would be helpful. (Section IV.F.2.)

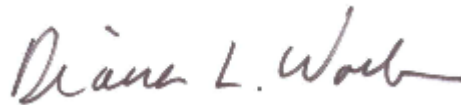
¹

These Section references are to sections of the Report.

Mr. Mazur
Mr. Werfel
Mr. Wilkins
May 22, 2013
Page 4

We very much appreciate your consideration of our recommendations and look forward to continuing to work with you.

Respectfully submitted,

A handwritten signature in dark ink, reading "Diana L. Wollman". The signature is fluid and cursive, with the first name "Diana" being more prominent than the last name "Wollman".

Diana L. Wollman
Chair

Enclosure

cc: Cameron Arterton
Associate Tax Legislative Counsel
Department of the Treasury

Lara Banjanin
General Attorney (International)
Internal Revenue Service

Ronald Dabrowski
Deputy Associate Chief Counsel (International)
Internal Revenue Service

Michael Danilack
Deputy Commissioner (International) LB&I
Internal Revenue Service

Scott Dinwiddie
Special Counsel (Income Tax and Accounting)
Internal Revenue Service

Jesse Eggert
Associate International Tax Counsel (Office of International Tax Counsel)
Department of the Treasury

Arlene Fitzpatrick
Attorney-Advisor (Office of International Tax Counsel)
Department of the Treasury

Mr. Mazur
Mr. Werfel
Mr. Wilkins
May 22, 2013
Page 5

Michael Hara
Attorney (Office of the Associate Chief Counsel (Administrative and Procedure)) Internal Revenue Service

James Hogan
Chief Branch 4 (Office of the Associate Chief Counsel (Passthroughs and Special Industries)) Internal Revenue Service

Cathy Hughes
Attorney Advisor (Tax Legislative Counsel (Office of Tax Policy))
Department of the Treasury

Michala Irons
Attorney (Office of Associate Chief Counsel (Passthroughs and Special Industries)) Internal Revenue Service

J. Mark Iwry
Senior Advisor to the Secretary & Deputy Assistant Secretary
(Retirement & Health Policy) Department of the Treasury

Lee Kelley
Deputy Tax Legislative Counsel (Office of Tax Policy)
Department of the Treasury

David H. Kirk
Attorney (Office of Associate Chief Counsel (Passthroughs and Special Industries)) Internal Revenue Service

Pamela Lew
Attorney (Financial Institutions and Products)
Internal Revenue Service

Melissa Liquerman
Chief Branch 2 (Office of the Associate Chief Counsel (Passthroughs and Special Industries)) Internal Revenue Service

Emily S. McMahon
Deputy Assistant Secretary (Tax Policy)
Department of Treasury

Adrienne Mikolashek
Attorney (Office of Chief Counsel (Passthroughs and Special Industries))
Internal Revenue Service

Mr. Mazur
Mr. Werfel
Mr. Wilkins
May 22, 2013
Page 6

Steven Musher
Associate Chief Counsel (International)
Internal Revenue Service

Danielle Nishida
Attorney Advisor (Office of the Associate Chief Counsel (International))
Internal Revenue Service

Danielle Rolfes
International Tax Counsel (Office of International Tax Counsel)
Department of the Treasury

Robert Stack
Deputy Assistant Secretary (International Tax Affairs)
Department of the Treasury

John Sweeney
Senior Technical Reviewer (Office of the Associate Chief Counsel (International))
Internal Revenue Service

Curtis G. Wilson
Associate Chief Counsel (Passthroughs and Special Industries)
Internal Revenue Service

Lisa Zarlenga
Tax Legislative Counsel
Department of the Treasury