REPORT #769

TAX SECTION

New York State Bar Association

Committee on Tax Preferences and AMT

Report on Provisions of H.R. 2141

Affecting the Taxation of Capital Gain

Table of Contents

Cover Letter: i
I. SUMMARY OF RECOMMENDATIONS 1
A. Capital Gain Exclusion for Small Business Stock 1
B. Provisions to Prevent Conversion of Ordinary Income into Capital Gain .. 1
II. CAPITAL GAIN EXCLUSION FOR QUALIFIED SMALL BUSINESS STOCK 2
A. Background 2
B. Policy Issues 3
C. Technical Comments 5
III. PROVISIONS TO PREVENT CONVERSION OF ORDINARY INCOME INTO 13
A. Conversion Transactions 13
B. Market Discount Bonds 26
C. Stripped Preferred Stock 28
Summary 31
I. H.R. 2264 Section 14226, Limitation on Section 936 Credit. 31
II. H.R. Section 14227. Modification to Limitation on Deduction for Certain Interest 33
III. H.R. 2264 Section 14235(b). Exclusion from Foreign Base 37
V. H.R. 2264 Section 14237. Denial of Portfolio Interest Exemption for Contingent Interest 45
VI. H. R. 2264 Section 1423-8. Regulations Dealing with Conduit Arrangements 50
VII. H.R. 2264 Section 14231. Earnings Invested in Excess Passive Assets ... 52
Policy Analysis 67
1. Lack of Tax Rationale 68
2 SEC Initiatives 69
3 Arbitrary and Inequitable Effects of Proposal 70
4. Competitive Effects 72
Technical Issues 72
Report on Eneroy Tax Provisions of H.R. 2141 76
1. Collection Mechanisms 77
a. Collection Point for Refined Petroleum Products. Coal and Natural Gas . 78
b. Electricity 79
2. Problems in Computing Rate of Tax on Electricity Produced by a Facility 81
a. Bulk power sales 81
b. Sales to small resellers 81
c. Periodic recomputation of tax rate 81
3. Taxation of Natural Gas Based on Assumed BTU Content 82
4. Exemptions and their Administration 82
a. Feedstock use 84

b. Fossil fuels used in the generation of electricity 85
c. Fuels used in the production of taxable energy products.....85

TAX SECTION
New York State Bar Association

June 11, 1993

Via Federal Express

Leslie B. Samuels
Assistant Secretary (Tax Policy)
United States Department of
the Treasury
Main Treasury Building
15th and Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Comments on Revenue Reconciliation Bill of 1993

Dear Les:

On behalf of the Tax Section, I am enclosing reports dealing with certain provisions of the Revenue Reconciliation Bill of 1993 (the "Bill") as passed by the House of Representatives. The reports deal with the following subjects: (i) international aspects; (ii) capital-gains related provisions; (iii) certain compensation-related provisions and (iv) the energy tax.

The provisions of the Bill which we have commended on are presently under consideration by the Senate Finance Committee, and are the subject of continuous re-examination in the professional and general media. Nevertheless, we believe it appropriate to deal with the Bill in the form passed by the House rather than any variations which may have been the subject of public speculation.

In light of time and logistical constraints we have not dealt with all of the provisions of the Bill. Instead, we have attempted to focus on those which raise tax policy issues properly within the scope of our accustomed role in commenting on proposed legislation. Our chief concern has been to highlight those features of the Bill which appear to us to be inconsistent with good tax policy, in particular provisions which will increase the already excessive complexity of the Code.

One fundamental issue which we have with the Bill is the degree to which it departs from the approach taken in the Tax Reform Act of 1986 to impose a uniform rate of tax on economic income. The 1986 Act took a large step in this direction by eliminating many tax preferences, subjecting capital gain and ordinary income to a uniform, historically low, rate of tax and otherwise eliminating inconsistency in tax treatment. As noted in the Joint Committee General Explanation of the 1986 Act:

> Congress desired a more efficient tax system. The prior tax law system intruded at nearly every level of decision making by businesses and consumers. The sharp reductions in individual and corporate tax rates provided by the Act and the elimination of many tax preferences will directly remove or lessen tax considerations in labor, investment, and consumption decisions. The Act enables businesses to compete on a more equal basis, and business success will be determined more by serving the changing needs of a dynamic economy and less by relying on subsidies provided by the tax code.

The Tax Section strongly supported the purpose of the 1986 Act, as quoted above. As practitioners, the members of the Tax Section believed, and continue to believe, that there are substantial benefits to the tax system, to its fair and efficient administration, and to business in general, in having a broad-based low-rate approach to taxation. At the same time the Tax Section criticized a number of features of the 1986 Act (particularly in the international area) which were perceived to be unfair or tended to increase complexity.

With that background in mind, we have to note that the general trend of the Bill is contrary to the purpose of the 1986 Act described above. The Bill sharply increases tax rates on ordinary income, and thereby creates a very substantial disparity between ordinary income and capital gain, and an even larger disparity between ordinary income and gain from small business stock qualifying for the new capital gain exclusion in Section 14113 of the Bill. To deal with the problem of the increased

ordinary income/capital gain disparity the Bill includes a provision (Section 14206) designed to prevent conversion of ordinary income into capital gain.

We understand that there are perceived revenue and fairness concerns which prompt these departures from the principles of the 1986 Act. While we have reservations about this approach, we acknowledge that the concerns reflected in the Bill raise fundamental economic and political issues. Nevertheless, we have felt it appropriate to criticize those features of the Bill which, in our view, unduly compromise good tax policy, unfairly discriminate, or unreasonably increase the complexity of the Code. On this basis, we have criticized, for example, the ordinary income conversion provision (suggesting instead a broadening of the straddle rule of Section 1092 of the Code), the disallowance of deductions for executive pay over $1 million (suggesting that like the Golden Parachute provision this disallowance provision deals with a subject better left to the Securities and Exchange Commission and state corporate law), certain features of the energy tax (including secondary liability imposed on certain sellers), and a number of the international provisions (including certain retroactive changes and the requirement of current taxation of the accumulated earnings of controlled foreign corporations having excessive “passive” assets).

Many of the features which we have criticized seem to us to be unfair or unworkable. In some cases, we have suggested what we believe to be more efficient approaches to achieve the desired goal. We hope these will be helpful in further legislative consideration of the Bill.

Please feel free to call me with any questions or comments.

Best regards.

Yours truly,

Peter C. Canellos

cc: Don Longano
Chief Tax Counsel
House Ways & Means Committee

Joseph Gale
Chief Tax Counsel
Senate Finance Committee

Harry L. Gutman
Chief of Staff
Joint Committee of Taxation

New York State Bar Association
Tax Section Committee on Tax Preferences and AMT

Report on Provisions of H.R. 2141 Affecting the Taxation of Capital Gain

This report[1] comments on Sections 14113 and 14206 of H. R. 2141, the Revenue Reconciliation Bill of 1993 (the "Bill"), as submitted on May 18, 1993 by the Committee on Ways and Means of the House of Representatives to the House Committee on the Budget. Section 14113 introduces a partial capital gain exclusion for new investments in small business stock, and is discussed in Part II below. Section 14206 includes provisions that would limit the availability of capital gains derived from certain financial market transactions. Three of those provisions, dealing with conversion transactions, market discount, and stripped preferred stock, are discussed in Part III below.

I. SUMMARY OF RECOMMENDATIONS

A. Capital Gain Exclusion for Small Business Stock

1. Minority investments in subsidiaries. In order for the benefits of the exclusion to be targeted to small business, minority interests held by individuals in subsidiaries of larger corporations should not be eligible for the exclusion.

2. Alternative minimum tax. Treating one-half of the excluded gain as a tax preference seriously blunts the effectiveness of the rule as an investment incentive, since few taxpayers can predict with any confidence that they will not be subject to the alternative minimum tax in the year of sale. We therefore recommend that the maximum rate of tax on qualifying gains be the same for taxpayers subject to the alternative minimum tax as it is for other taxpayers.

B. Provisions to Prevent Conversion of Ordinary Income into Capital Gain

1. Conversion transactions. Proposed Section 1258 is a far too complex way to fulfill its stated purpose of preventing taxpayers from using financial transactions to create long-term capital gains that benefit from the newly expanded capital gains

[1] This report was prepared by Stephen B. Land, Erika W. Nijenhuis, and Marsha M. Quinn. Helpful comments were received from Katherine M. Bristor, Peter C. Canellos, John A. Corry, Edward D. Kleiribard, James M. Peaslee, Richard L. Reinhold, Ivan Ross, and Michael L. Schler.

rate differential. An extension and simplification of the existing straddle rules would be a better approach. While Section 1258 goes further than the straddle rules to prevent the conversion of ordinary income into short-term capital gains that can be offset by capital losses, we believe that restrictions on the use of capital losses should not be further tightened until Congress addresses the problems, aggravated by Arkansas Best, that arise when financial transactions are used to hedge ordinary business risks.

2. Market discount. The Committee believes that transition rules should not be subsequently modified with retroactive effect. Because the proposed extension of the market discount rules to pre-1984 bonds would affect only purchasers of these bonds after April 30, 1993, the Committee does not regard the proposed extension as a retroactive change, and is therefore not opposed to the proposal.

3. Stripped preferred stock. While treating stripped preferred stock in a manner similar to stripped bonds has considerable merit, the matter should be addressed comprehensively, rather than with rules that cover only the holder of stripped stock. In particular, the appropriate effects on the dividends received deduction, which has no analogy in the stripped bond context, need to be considered.

II. CAPITAL GAIN EXCLUSION FOR QUALIFIED SMALL BUSINESS STOCK

A. Background

Section 14113(a) of the Bill contains new proposed Section 1202,[2] which allows taxpayers to exclude from gross income fifty percent of gain received from the sale of "qualified small business stock." The stock must have been held for more than five years, and the total amount of gain eligible for the exclusion is limited to $10 million or 10 times the taxpayer's basis, whichever is greater. The stock must have been acquired upon original issuance from a corporation with an aggregate capitalization of no more than $50 million. Throughout the taxpayer's holding period, the issuer must be a domestic C corporation engaged in a qualifying trade or business. Certain types of businesses are excluded, including most professional and financial services businesses, farms, extractive businesses, and hotel and restaurant operations.

[2] Except where otherwise indicated, all Section references are to the Internal Revenue Code of 1986, as amended ("the Code").

The statute provides that a taxpayer receiving stock in certain tax-free and other transfers (such as a gift, inheritance, or distribution from a partnership) is treated as having acquired the stock in the same manner as the transferor and as having held the stock during the time it was held by the transferor. Stock received in exchange for qualified small business stock in a tax-free reorganization also qualifies for the exclusion, but only to the extent of gain accrued before the' reorganization.

One-half of the excluded gain is a preference item for alternative minimum tax purposes.

B. Policy Issues

1. In general. From our perspective as practicing tax lawyers, we generally oppose adding provisions that create special categories of tax-favored income, because these provisions add complexity to the tax law and create distinctions that are often more illusory than real. We recognize that the proposed capital gains exclusion is intended as an incentive to aid small business in raising new equity capital. However, using the tax law to create this investment incentive artificially segments the capital markets for this type of investment, since investors that cannot benefit from the exclusion, such as foreign or tax- exempt investors, may be crowded out by investors that do expect to benefit. It is possible therefore, that the proposed exclusion will redirect capital flows without significantly increasing in the aggregate the amount of capital made available to small business.

The ultimate merits of the exclusion, however, depend on matters beyond the Committee's purview, such as the desirability, as a matter of economic policy, of promoting one particular class of business investments rather than another. Our comments, therefore, focus on how the proposal can be made to achieve its purpose in a manner that is as effective and fair as possible, without the loss of tax revenues on transactions outside its intended scope.

2. Subsidiaries. Section 1202 as written would allow large companies to issue interests in subsidiaries to individuals (in some cases as a form of incentive compensation) who would then be entitled to the benefit of the capital gain exclusion. We suspect that such a benefit is outside the intended scope of the statute, since subsidiaries of larger companies are unlikely to have the same difficulties as independent small businesses in attracting equity financing. These subsidiaries could be excluded

by measuring aggregate capitalization under subsection (d)(2)[3] on a combined basis for a group of related corporations.

At a minimum, corporations that are part of an affiliated group under Section 1504(a), without regard to the exclusions in Section 1504(b), should be treated as related for this purpose. The threshold percentage might be lowered form 80 percent to as low as 50 percent. Alternatively, the relevant group could be a controlled group under Section 1563(a), which has a much broader scope. Such a broader rule, however, could deny the benefits of the capital gain exclusion to investments in otherwise unrelated corporations that happen to have significant overlap among their investors.

3. Alternative minimum tax. Section 14113(b) of the Bill provides that one-half of the excluded gain is a preference item for purposes of the alternative minimum tax. This provision would cause capital gain on qualified small business stock to be taxed at an effective rate of up to 21 percent under the proposed new rate schedule for the alternative minimum tax.[4] The maximum effective regular tax rate on such gain would be only 14 percent. An investor's evaluation of a proposed investment in qualified small business stock will therefore depend in part on the investor’s expectations of his or her alternative minimum tax position in the year of sale.

Predictions of one’s potential exposure to the alternative minimum tax are difficult even in the short term. As a practical matter, therefore, investors are unlikely to count on the 14 percent rate in making investment decisions. Consequently, the proposed capital gain exclusion will act as an investment incentive primarily to the extent that it reduces the effective rate from 28 to 21 percent. To the extent that the effective rate is further reduced to 14 percent for investors who happen not to be subject to the alternative minimum tax in the year of sale, the additional reduction will generally be a windfall.

To be sure, there is always a conflict between the policy reasons behind a tax preference item and the objective of the alternative minimum tax to ensure an equitable distribution of the federal income tax burden. In this instance, however, the conflict is particularly acute because of the uncertainty in

---

[3] In this part of the report, all subsection and paragraph references are to subsections and paragraphs of proposed Section 1202.

[4] Because the preference is an “exclusion-type” preference, it would not give rise to a minimum tax credit in later years. See Bill Section 14113(b), mending Code Section 53(d)(1)(B)(ii).

predicting future alternative minimum tax exposure. We therefore recommend that a single maximum rate of tax apply regardless of whether the investor is subject to alternative minimum tax in the year of sale. This rate could be 14 percent, 21 percent or somewhere in between.

C. Technical Comments

1. Holding period. Requiring a five-year holding period in order to qualify for the exclusion creates a dilemma for the investor who has an opportunity to sell early. Frequently, new equity investments in small companies are highly illiquid, and investors expect that a long period may be necessary before they can realize a profit on their investment. Nonetheless, business conditions can change rapidly, and a buyout proposal may appear before the end of the five-year holding period. In such a case, the investor might be discouraged for tax reasons from selling at that time, even though the sale may be in the best interests of the company (for example, the acquiror may be a larger corporation with resources to expand the business further). This lock-in effect is greater than the general lock-in caused by the deferral of tax on unrealized gains, because selling early doubles the rate of tax. In some cases the difficulty can be resolved by structuring the acquisition as a tax-free reorganization, but this option will not always be practical, and there is no reason why the capital gains exclusion should create a bias in favor of this form of acquisition.

Whether retaining the five-year holding period protects revenues depends on the extent to which investors will delay dispositions (or structure them on a tax-free basis) in order to benefit from the exclusion. Churning is not possible in this context because the exclusion applies only to stock purchased at original issue. We recognize that the five-year holding period requirement serves the legitimate function of restricting the benefits of the capital gain to long-term investors. The side effects that we have noted, however, should be kept in mind in determining how long the appropriate holding period requirement should be.

2. Limitation of eligible gain. Subsection (b) limits the aggregate amount of gain eligible for exclusion from gross income with respect to the stock of each corporation owned by a taxpayer to the greater of $10 million or 10 times the taxpayer's aggregate basis in such stock. The $10 million limitation applies separately to each taxpayer on the cumulative gain on stock of each corporation owned by the taxpayer. The reference to “aggregate gain” in subparagraph (b)(1)(A), however, creates the misleading impression that the cumulative $10 million limitation

is applied by taking into account sales made in prior years by all shareholders of the corporation. To clarify that the limitation applies on a per taxpayer basis, we suggest adding "by the taxpayer" after "account" in subparagraph (b)(1)(A).

The flush language in subsection (b) provides that the basis of any stock is determined without taking into account any addition to basis after the date on which the stock was originally issued. This provision could restrict the amount of gain eligible for the exclusion in the case of a taxpayer owning qualified small business stock who later contributed money or property to the issuer that could have been, but was not, contributed in exchange for additional qualified small business stock. A taxpayer who did receive additional stock in exchange for a later contribution would have additional basis attributable to the increased number of shares. We therefore recommend that these additions to basis be taken into account provided that (i) stock issued at the time of the later contribution would have been qualified small business stock, and (ii) the holding period requirement would have been satisfied with respect to such stock.

Regardless of whether the suggestion in the preceding paragraph is adopted, a clarification is needed regarding the computation of basis attributable to contributed property. Subsection (i) provides that for purposes of Section 1202, the basis of contributed property shall be no less than its fair market value; this rule is intended to prevent pre-contribution gain from being eligible for the exclusion.[5] By its literal terms this rule also appears to apply for purposes of computing the limitation of eligible gain to 10 times basis. If this is the intended result, it might be useful to include a statement to that effect in the legislative history; if not, subsection (i) should be amended, possibly by changing its initial words from "For purposes of this Section" to "For purposes of subsection (a)." Any such change, however, should also take into account our comments below regarding subsection (i) as it might apply to the measurement of aggregate capitalization and to tax-free reorganizations.

3. Qualified small business stock. Subsection (c) defines "qualified small business stock" as stock of a C corporation issued after December 31, 1992, if (i) the issuer is a "qualified small business" on the date of issuance and throughout the taxpayer's holding period is engaged in an active

[5] A consequence of this rule is that each share of qualified small business stock received in exchange for a contribution of appreciated property has a split basis: a fair market value basis for determining gain eligible for the exclusion, and a cost basis for determining the balance of the gain.

trade or business, and (ii) the taxpayer receives the stock upon original issuance (subject to certain exceptions for tax-free and other transfers described below) for money, property (other them stock), or services to the issuer.

Stock issued upon the conversion of an ongoing partnership to a corporate form of doing business can be qualified small business stock under this definition, even though no fresh capital may be contributed to the business enterprise at that time. Assuming this result is intended, a similar result should arguably apply to an S corporation that terminates its election.

Paragraph (c)(3) excludes stock from the definition of "qualified small business stock" if (i) during the period beginning two years before and ending two years after the issuance, the issuer or a related entity purchases any stock of the issuer from the taxpayer or a related person, or (ii) during the period beginning one year before and ending one year after the issuance, the issuer or a related entity purchases stock of the issuer with an aggregate value greater than five percent of the aggregate value of all of its stock as of the date one year before the issuance. The subsection prevents a taxpayer from converting shares held before the effective date of the proposed legislation (and thus not eligible for the exclusion) into shares that are eligible for the exclusion. Absent paragraph (c)(3), a taxpayer might seek to redeem old shares and then recontribute the proceeds for new shares eligible for the exclusion.

These redemption rules would not prevent a taxpayer from selling old stock to a tax-exempt or non-taxpaying entity interested in investing in the issuer and then purchasing new shares of the issuer in order to reap the benefit of the exclusion without increasing the taxpayer's investment in the business. Such a case might not be regarded as abusive, since the issuer would obtain new equity capital as a result of the transactions. In effect, the new investor, which because of its tax status is unable to benefit from the exclusion, would be able to transfer the benefits of the exclusion to a continuing investor. This result, if unwanted, can be avoided by disallowing the exclusion for gain on stock to the extent the taxpayer or a related person has sold stock of the issuer or a related entity at any time within the previous two years.

The redemption rules are unreasonably harsh in that after a covered redemption no stock issued during the applicable pre- and post-redemption periods is entitled to any exclusion from gain. This result unfairly disallows a capital gain exclusion for stock purchased with funds in excess of the amount paid out in the redemption. The excess represents new investment

in the issuer and is within the intended scope of proposed capital gain exclusion. The redemption rules should therefore apply only to the first stock that is issued during the pre- and post-redemption periods for consideration equal to the amount paid out on the redemption, and any additional stock issued during these periods could potentially be qualified small business stock if the other requirements are met.

In addition, it may be useful to include a statement in the legislative history that a redemption is treated as a purchase for purposes of paragraph (c)(3) regardless of whether it is treated by the shareholder as a sale or a dividend under Section 302.

4. Qualified small business. Subsection (d) defines the term "qualified small business" as a domestic C corporation (or any predecessor) with an aggregate capitalization at all times after January 1, 1993 and before the issuance that is no greater than $50 million, and with an aggregate capitalization immediately after the issuance, including amounts received in the issuance, that is no greater them $50 million. The test appears to apply continuously during this period: if the capitalization exceeds $50 million at any point in time during this period, the corporation is no longer a qualified small business.

Applying this test on a continuous basis is needlessly complicated for taxpayers and the Internal Revenue Service (the "Service"). It would appear sufficient if the test were applied only at the end of each taxable year. An anti-abuse rule can take care of extraordinary distributions before year-end that are recontributed the following year.

If the test were applied only at the end of each taxable year, periods before 1993 could be covered without creating an undue burden. We see no reason, however, why the test should look back indefinitely to all prior years of the corporation and its predecessors. A five-year look-back period should be enough to ensure that the corporation is a sufficiently small business to be within the intended scope of the capital gain exclusion. It might also be appropriate to allow a "fresh start" for a business emerging from bankruptcy, since its pre-bankruptcy capitalization is not particularly relevant to its post-bankruptcy prospects.

We suggested earlier that aggregate capitalization be measured on a combined basis for a group of related corporations. In determining which corporations are to be included within the related group, we believe that only those corporations that are within the group immediately after the stock issuance should be included. If, instead, the test took into account the

capitalization of corporations that were formerly affiliated with the issuer, it may require information that is no longer available to the issuer as a practical matter.

Some clarification is needed on what constitutes a "predecessor" for purposes of subparagraph (d)(1)(A). Presumably, at a minimum a corporation from which tax attributes are carried over under Section 381 is a predecessor. Congress should consider whether the former owner of a spun-off subsidiary or division should also be considered a predecessor. The size, of the former owner is not likely to be relevant to the subsequent ability of the spun-off corporation to raise equity capital. Moreover, the existing restrictions on the ability to engage in a spin-off minimize the likelihood that a spin-off will be undertaken solely for the purpose of benefitting from the proposed rule. If the former parent is to be considered a predecessor, however, it would be useful to clarify whether the subsidiary's prospective ability to issue qualified small business stock can be a valid business purpose for the spin-off. In addition, it should be clarified that the spun-off stock does not qualify for the exception since it does not represent the infusion of new capital.

Subparagraph (d)(2)(A) states that aggregate capitalization is the excess of the amount of cash plus the aggregate adjusted bases of other property held by the corporation over the aggregate amount of short-term indebtedness of the corporation. We agree that measuring capitalization using adjusted basis rather than fair market value is the better approach, since it avoids valuation controversies. It appears that the literal terms of subsection (i) require that the basis of contributed property be treated for this purpose as no lower than its fair market value at the time of contribution, although it is unclear how subsequent adjustments are to be made. Perhaps in the interests of simplicity subsection (i) should not apply here, and aggregate capitalization should be measured solely by reference to adjusted basis.

5. Active trade or business. Subsection (e) provides that in order to meet the active business requirement, at least 80 percent (by value) of a corporation's assets must be used in the active conduct of a qualified trade or business and the corporation must be an "eligible corporation." We suggest that subparagraph (1)(A), which sets forth the 80 percent test, clearly state that the requisite 80 percent of assets can be spread among more than one qualified trade or business.

Subparagraph (e)(1)(B) sets forth the "eligible corporation" requirement, and paragraph (e)(4) defines an

eligible corporation as a C corporation other than a DISC or former DISC, a corporation that has a Section 936 election in effect, a regulated investment company, real estate investment trust, REMIC, or a cooperative. As a drafting matter, we believe that the concept of an eligible corporation should not be included as a component of the active business requirement, but should be stated as an independent requirement. We recommend, therefore, that the "eligible corporation" requirement be added to the definition of qualified small business stock in subsection (c), and that the definition of an "eligible corporation" be removed from subsection (e) and placed in subsection (c) or a separate subsection.

Paragraph (e)(5)(B) states that a corporation will fail to have an active business during any time in which more than 10 percent of the value of its assets (in excess of liabilities) consists of portfolio stock or securities, defined as stock or securities in other corporations that are not more than 50 percent (by vote or value) owned by the corporation (excluding working capital). Paragraph (e)(7) states that a corporation will fail to have an active business during any time in which more than 10 percent of the value of its assets (not reduced by liabilities) consists of real property not used in the active conduct of a trade or business. For this purpose, owning, dealing in, or renting real property does not qualify as a trade or business. Compliance with these tests may in some cases be virtually impossible as a practical matter since they are based on fair market values and apply continuously over the taxpayer's holding period. The administrative burden would be greatly reduced if the test were applied only at the close of each taxable year. In addition, consideration should be given to applying both tests with reference to asset basis rather than fair market value, with a possible exception for highly appreciated assets (e.g., with a value at least twice basis).

The limitations on portfolio assets and real estate should be conformed in their technical details so that in both cases the 10 percent limitations are based on either total assets or assets net of liabilities. If the limitations are to be based on assets net of liabilities, the statute should be clarified to indicate whether liabilities include only short-term liabilities (as in subparagraph (d)(2)(B)) or all liabilities.

Paragraph (e)(6) treats as assets used in a qualified trade or business (and exempts from the portfolio asset restriction) any assets currently needed for working capital or expected to be needed for working capital or research and experimentation within the next two years. This provision fails to cover assets needed to fund other types of investment (such as

plant and equipment) in the near future. Instead of a specialized definition of working capital assets for this purpose, consideration should be given to covering all assets retained for the reasonable needs of the business in the same manner as that test is applied under Section 535(c) for purposes of the accumulated earnings tax credit. While that test is subject to some uncertainty and has led to litigation in its application, we expect that the same will be true of the definition now in paragraph (e)(6), and use of the accumulated earnings tax rule will make a body of interpretive authority immediately available.

6. Pass-through entities and tax-free exchanges. Subparagraph (h)(2)(C) permits stock distributed by a partnership to be treated as qualified small business stock in the hands of the partner if the stock was qualified small business stock, in the hands of the partnership and the partner was a partner during the entire period the stock was held by the partnership. We believe that this rule should apply only to the extent of the partner's interest in the partnership on the date the stock was acquired by the partnership (which would parallel the result in the case where the partnership sold the stock and allocated the gain to the partner). It is unclear whether the current reference in subparagraph (h)(2)(C) to "requirements similar to the requirements of subsection (g)" is intended to accomplish this result.

The explanation provided by the House Ways and Means Committee (the "Ways and Means Explanation")[6] states that if qualified small business stock is transferred to a partnership, any gain subsequently realized by the partnership is not eligible for the exclusion. This rule is too restrictive in view of the other provisions governing tax-free transfers. We recommend that, in such a case, the contributing partner be entitled to the capital gain exclusion to the extent of the partner's share of the qualifying gain when the partnership disposes of the stock.

Subsection (f) provides that stock will be qualified small business stock if it is acquired upon the conversion of other qualified small business stock, and permits a tacking of the holding period. The heading to subsection (f) misleadingly refers to conversion of "preferred" stock, while the text properly refers to the conversion of "other" stock, thereby covering convertible common stock. We suggest replacing the word "preferred" with "other* in the heading.

---

[6] Committee on Ways and Means, U.S. House of Representatives, Fiscal Year 1994. Budget Reconciliation Recommendations of the Committee on Ways and Means (Comm. Print 1993).

The rules in subsection (h) regarding tax-free reorganizations reach an appropriate result where qualified small business stock is exchanged for stock which would not otherwise be qualified small business stock. If, however, the stock received in the exchange would be qualified small business stock without regard to subsection (h), there should be tacking of holding periods, and pre- and post- reorganization gain or loss should be combined and taken into account on the ultimate sale of the new stock. The statute as drafted does not explicitly cover this case. Also, in the case of stock exchanged in a recapitalization or an “F” reorganization, the rule should be the same as the rule for convertible stock in subsection (f): the new stock should inherit the old stock’s status as qualified small business stock (regardless of the aggregate capitalization of the issuer at that time), and the eligible gain should not be limited to gain accrued before the exchange.

Subparagraph (h)(4)(D) states that the treatment of stock received in a 351 transaction will be treated as qualifying small business stock only if the 351 transaction gives the transferee corporation control (within the meaning of Section 368(c)) of a qualifying small business. The control test would prevent a taxpayer holding a small interest in a qualifying small business from contributing the interest to a corporation, unless shareholders holding in the aggregate at least 80 percent of the stock also contributed their shares to the corporation. We recognize that this control test is intended to disallow the capital gain exclusion following a tax-free transaction that does not in effect result in the acquisition of the qualified small business. In our view, however, the limitation of the eligible gain to gain accrued before the contribution is itself a sufficient restriction. We therefore suggest eliminating this restriction.

If this suggestion is not adopted generally, at the least the control test restriction should not apply where the investor has already satisfied the five-year holding period requirement at the time of the exchange. Otherwise, none of the investor's gain, when ultimately recognized, will be eligible for the exclusion, even though the pre-contribution gain would have been eligible if the stock had been sold at that time rather than contributed. Also, we recommend two clarifications to subparagraph (h)(4)(D) as written. First, the opening words should be “In the case of a transaction described in Section 351” rather them “Except in the case of a transaction described in section 368.” Second, the reference to direct or indirect control within the meaning of Section 368(c) is too vague. Section 368(c) itself is based solely on direct ownership, and no stock attribution rules expressly apply for this purpose. If stock

attribution is intended to apply here, it should be made explicit, rather than by reference to "indirect" control.

III. PROVISIONS TO PREVENT CONVERSION OF ORDINARY INCOME INTO CAPITAL GAIN

The provisions of Section 14206 of the Bill that are discussed in this Part are

- a requirement that capital gain on certain "conversion transactions" involving the sale of a capital asset be recharacterized as ordinary income to the extent of an imputed rate of return on the transaction;

- the elimination of transition rules for market discount bonds issued prior to July 19, 1984, and the treatment of accrued market discount on tax-exempt bonds as taxable ordinary income; and

- a requirement that amounts equal to original issue discount be accrued and included in income by holders of certain stripped preferred stock.:

While Section 14206 is included in a part of the Bill labeled "Individual Income and Estate and Gift Tax Provisions," these provisions would affect the taxation of corporations as well as individuals.

A. Conversion Transactions

1. Background. Prior to the Economic Recovery Tax Act of 1981, many taxpayers entered into straddles involving the use of a variety of financial instruments that were intended to expose the taxpayer to little or no economic risk, but that would for tax purposes (i) generate a loss in the taxpayer's current year and income in a later year, and/or (ii) convert ordinary income or short-term capital gain into long-term capital gain, which was taxed at preferential rates.[7] The taxpayer's current year loss from straddles would be used to offset economic income from other activities. In the subsequent year, the taxpayer either would pay the tax on the income rolled forward from the

[7] For detailed discussion of straddle techniques, see Commodity "Tax Straddles." Hearing Before the Committee on Ways and Means. House of Representatives, 97th Cong. 1st Sess. (April 31, 1981) (reprinting pamphlet by the staff of the Joint Committee on Taxation); Staff of the Joint Committee on Taxation, General Explanation of the Economic Recovery Tax Act of 1981. at 279-83 (Jt. Comm. Print 1981); Harry Lee Smith. 78 T.C. 350 (1982) (futures straddles); Barry L. Glass; 87 T.C. 1087 (1986) (options straddles).

prior year, or would enter into another straddle. By entering into new straddles each year, some taxpayers were able to defer for extended periods paying tax on substantial amounts of income.

In 1977, the Service issued a revenue ruling that disallowed losses claimed by taxpayers from straddle transactions.[8] The Service also began to litigate straddle cases. By 1981 hundreds of straddle cases were under litigation.

The Economic Recovery Tax Act of 1981 sought to foreclose many of the popular straddle techniques by adding Sections 1092 and 263(g) to the Internal Revenue Code (the "straddle rules"). Section 1092 and its regulations provide generally that (i) an otherwise allowable loss on a position in personal property is deferred to the extent of unrecognized gain on any offsetting position (or certain successor positions), and (ii) the holding period of property held as a position in a straddle (and not held for the long-term capital gain holding period prior to the establishment of the straddle) is terminated, and the property is treated as acquired no earlier them the date on which no offsetting position exists, thereby vitiating strategies intended to "age" unrealized short-term capital gain into long-term gain while substantially eliminating the taxpayer's economic risk. In addition, under Section 263(g), interest expense and other carrying charges allocable to personal property that is part of a straddle must be capitalized.

For example, assume taxpayer X (who is not a dealer in gold) borrows $100 at an annual 6 percent rate, buys $100 worth of gold, and sells the gold forward for $106 for delivery in just over one year's time. Absent sections 1092 and 263(g), X would incur $6 of ordinary interest expense and recognize $6 of long term capital gain from the transaction. Under the straddle rules, however, X's basis for the gold will be $106 at the time that the forward is exercised, and X will recognize no gain or loss on the transaction. If X entered into the same transaction using its own funds rather than borrowed funds, X would realize $6 of capital gain, which under the straddle rules would be short-term gain. The pricing of a forward contract to sell gold is based on the current spot price of gold, adjusted to reflect (i) a risk-free rate of return on the funds invested in the gold and (ii) the costs of carrying gold, such as warehousing costs and insurance. The $6 capital gain in this transaction would be therefore attributable in large part to the time value of money.

---

[8] Revenue Ruling 77-185, 1977-1 C.B. 48.

While this transaction, and other financial transactions involving (in the most straightforward case) the current purchase of property and a contemporaneous agreement to sell that property in the future, lock in profits that economically are attributable in large part to the time value of money, under current law the profits from these transactions are treated wholly as capital gain for federal income tax purposes.[9] These transactions often (but not always) contain as one of their constituent components derivative financial instruments, such as forwards, futures and options, because the pricing for such instruments is related to cash market prices in ways that involve the time value of money. Under current law, however, the straddle rules substantially limit a taxpayer's ability to convert short-term capital gain to long-term capital gain, and (by requiring the capitalization of interest expense incurred in leveraged transactions) vitiate as a practical matter a typical taxpayer's ability to convert ordinary income into capital gain. In addition, in a low interest rate environment, there are significant practical limitations on a taxpayer's ability to convert what would otherwise be interest income into capital gain.

While the tax straddle rules do not apply to every conceivable cash-and-carry or similar transaction, there is little incentive under current law for taxpayers to enter into such transactions as tax rate arbitrages, as there is no rate differential between long-term capital gains and ordinary income for corporations, and only a 3 percent rate differential for individuals.[10]

The Bill proposes to tax individuals at rates as high as 39.6 percent on ordinary investment income, while retaining current law's 28 percent maximum tax rate on long-term capital gain. Apparently out of a concern that individuals will use cash-and-carry and similar transactions to generate substantial amounts of long-term capital gain taxed at preferential rates, the Bill proposes to add new Section 1258 to the Code.

Section 1258 generally would require a taxpayer to recharacterize capital gain derived from a “conversion transaction” as ordinary income, to the extent of an imputed

---

[9] Cash purchase/forward sale strategies intended to give rise to capital gain have different names in different markets, but have similar economic characteristics. The gold transaction described above, for example, is called a “cash-and-carry,” while a similar transaction in stock is called a “conversion” in the marketplace.

[10] Taxpayers still may enter into such transactions in order to generate capital gain to offset unrelated capital losses, which would not be deductible against ordinary income (except, in the case of individuals, to the extent of $3,000 per year).

money-market rate of return on the taxpayer's net investment in the transaction. The recharacterization would apply to gain that otherwise would constitute either long-term or short-term capital gain, notwithstanding the absence of a tax rate differential between short-term capital gain and ordinary income (or a rate differential between any capital gain and ordinary income in the case of corporations). Moreover, because Section 1258 would recharacterize capital gain as ordinary income, but not capital loss as ordinary loss, a "reverse conversion" (i.e., a transaction in which a taxpayer sells property short and enters into a contract to buy the property in the future, in effect achieving a borrowing of funds) would continue to give rise to capital loss, even though that loss can be said to be analogous to interest expense to precisely the same extent that gain from a conversion is analogous to interest income.[11]" Section 1258 would apply to conversion transactions entered into after April 30, 1993.

2. Policy Issues. As a policy matter, the Committee believes that the need for Section 1258 to prevent the conversion of ordinary income into capital gain has been overstated. Most of the potential abuses that new Section 1258 appears to be aimed at are dealt with by the straddle rules, which across a broad range of transactions effectively prohibit a taxpayer from converting ordinary income into capital gain through leveraged cash-and-carry arrangements, and which also effectively preclude a taxpayer from converting short-term capital gain into long-term capital gain. Moreover, the refusal to treat reverse conversions as giving rise to ordinary loss creates an asymmetry that undercuts any argument that Section 1258 is intended simply to reflect the economic substance of transactions within its scope.[12] Finally, in today's low interest rate environment, the amount of cash that must be invested in an unleveraged conversion transaction in order to generate any significant capital gain is

---

[11] For example, a taxpayer that sells gold short for $100, and enters into put and call options that create a synthetic forward contract to buy gold for $106 ("a reverse conversion") will continue to recognize $6 of capital loss.

[12] A Coordinated Issue Paper prepared in October 1991 as part of the Service's Industry Specialization Program, which provides industry- and issue-specific guidance to revenue agents, concluded that a securities dealer that enters into a reverse conversion recognizes capital loss rather them ordinary loss on the options used as part of the transaction, even if the securities dealer uses the reverse conversion transaction as a means of funding itself, which the paper recognized as a valid business purpose for the transaction. See Internal Revenue Service, Industry Specialization Program Coordinated Issue Papers, at S-118 (published as a special supplement by the Bureau of National Affairs as Report No. 95, May 15, 1992).

of a sufficient magnitude that few taxpayers are likely to hold uninvested cash in that amount, and taxpayers that do have such amounts of cash available are likely to invest that cash in more remunerative transactions.[13]

Section 1258 is not a mere expansion of an existing, already well-understood, provision of the Code, but a complex new provision that introduces new concepts that will undoubtedly require significant development through regulation and other administrative guidance.[14] Our technical comments in the next section of this report describe some of the difficult issues raised by this provision. In sum, particularly in an era of low prevailing interest rates, Section 1258 operates as an overly complex solution to a very limited problem. Accordingly, the Committee recommends expansion (and simplification) of the straddle rules rather than the enactment of Section 1258.

Under current law, the straddle rules do not apply to transactions involving stock that are excluded under Section 1092(d)(3). As proposed, Section 1258 would expand the scope of the straddle rules, solely for purposes of Section 1258, to include stock. The Service has recently issued proposed regulations under Section 1092(d)(3)(B)(i)(II), however, the effect of which would be substantially to expand the scope of stock-related transactions subject to the straddle rules. The Committee believes that repeal of Section 1092(d)(3) would achieve much the same effect, as well as accomplishing substantially all of the stated aims of proposed Section 1258, while also providing significant simplification of the straddle rules. We are unaware of any techniques for generating long-term capital gain that would be covered by Section 1258 but which

---

[13] Using market prices from early May 1993, for example, a taxpayer that purchased in May 1993 1000 troy ounces of gold, at a cost of $354,000, and simultaneously entered into a futures contract to sell 1000 troy ounces of gold for October 1993 delivery, at a price of $360,000, would realize only $6000 of gain --a return of approximately 1.7 percent on the initial investment of $354,000. Similarly, a taxpayer that purchased in May 1993 1000 shares of IBM stock, at a cost of $4 8,250, and simultaneously purchased a put and sold a call on IBM stock, each expiring in July 1993 and each with a strike price of $50,000, at a net cost of $1325, would realize only $425 on the transaction --a net return of less than .9 percent on the initial $49,575 investment (apart from any dividends that may be received on the stock). At these rates of return, an investment of $50 million dollars would be required to generate, respectively, approximately $850,000 or $430,000 of gain.

[14] The reaction of one commentator is illustrative: “[Section 14206 of the Bill] would add a new section 1258 to the code that only a New York tax lawyer could love. This wildly complex provision would ….” Sheppard, “Sen. Danforth's Subtle Threats,” Highlights & Documents 1662, 1664 (May 6, 1993).

would not be covered by an appropriate expansion of the straddle rules. It is possible, of course, that such techniques may evolve in the future; but it would be better to fashion an appropriate response at that time rather than introduce now a provision as complex as Section 1258 simply to foreclose that possibility.

The Committee recognizes that the recommended expansion of the straddle rules would not affect transactions entered into in order to generate capital gains to offset expiring capital losses, while Section 1258 would do so. The Ways and Means Explanation, however, describes the abuse at which Section 1258 is directed as transactions entered into to benefit from the newly expanded rate differential between long-term capital gains and ordinary income. Moreover, the Committee believes any concerns about transactions entered into in order to avoid losing the benefits of capital loss carry forwards should be directed in the first instance to remedying the inequitable rules of current law that may require taxpayers to recognize capital losses from transactions that historically have been viewed as giving rise to ordinary loss, and then provide only a short period during which such losses incurred by corporations can be carried forward.[15]

3. Technical Comments. As a preliminary matter, if the purpose of proposed Section 1258 is, as stated in the Ways and Means Explanation, to limit transactions based on the rate differential between long-term capital gains and ordinary income, the effect of Section 1258 should be limited to recharacterizing long-term capital gains only. More detailed comments are provided below on the definition of a conversion transaction, the determination of the amount of capital gain recharacterized as ordinary income, and the character of the income recharacterized.

a. Definition of Conversion Transaction. To meet the definition of a "conversion transaction" for purposes of proposed Section 1258, a taxpayer must (prior to the application of

---

[15] Under the Service's current reading of Arkansas Best Corporation v. Commissioner, 485 U.S. 212 (1988), taxpayers may incur substantial capital losses in hedging transactions entered into to manage business risks that cannot be offset by income from related property. For example, under the Service's view of Arkansas Best, a taxpayer that hedges the risk that its inventory will fall in price by entering into a forward or futures contract may realize ordinary income from the inventory and capital loss from the offsetting forward or futures contract. Under section 1212, a capital loss incurred by a corporation generally may be carried back three years and forward five years. Congress has recognized that uncertainty over the proper scope of Arkansas Best may deter a variety of desirable business hedging transactions, and has urged that appropriate steps be taken. Statement of the Managers, Revenue Bill of 1992, H.R. 11, at 127 (released October 6, 1992).

Section 1258) derive capital gain on the disposition of property held in a transaction that both (i) constitutes a transaction "substantially all" of whose expected return is attributable to the time value of the taxpayer's net investment in the transaction ("a time value of money transaction"), and (ii) falls within one of four categories described below.

Although a conversion transaction must be one in which substantially all of the expected net return is attributable to the time value of the taxpayer's net investment in the transaction, the term "substantially all" is not defined for this purpose. This fact alone may lead to significant difficulties in interpreting Section 1258. Even straightforward cash-and-carry transactions have implicit yields that differ from one another, to reflect (i) differing relative economic efficiencies of different markets, (ii) the costs of holding the physical property in question, and (iii) the returns (by way, for example, of borrow fees, interest or dividends) that are expected to be earned on such property over the term of the cash-and-carry.[16] We recommend that a "bright line" standard, such as 80 percent, be used to define "substantially all" for this purpose. Absent such a clear rule, cautious taxpayers will be deterred from legitimate transactions because of uncertainty over the tax treatment, while aggressive taxpayers will interpret the standard in a manner favorable to themselves.

Regardless of how "substantially all" is defined, issues will arise regarding the proper scope of a "transaction" for this purpose. If a taxpayer buys $200 worth of gold and sells $100 short, it is likely that less them substantially all of the expected return from the transaction will be attributable to the time value of money, since the taxpayer is exposed to fluctuations in the market price of gold with respect to one-half of the investment. In this case it is easy to identify the unhedged portion of the investment and exclude it from the "transaction" for this purpose, but more complicated partial hedging strategies may be more deeply embedded in larger transactions.

The definition of a "conversion transaction" contains two specific categories of time value of money transactions that will be treated as conversion transactions and two broader categories. The first specific category includes time value of money transactions that consist of the simultaneous acquisition

[16] Thus, the examples offered earlier of a gold cash-and- carry and an IBM stock "conversion" are based on newspaper quotations for the same day, but reflect significantly different apparent rates of return, which may in part reflect different costs to carry and expected cash returns (borrow fees and dividends) during the term of the transaction.

of property and entering into a contract to sell such property or substantially identical property. The second specific category includes any "applicable straddle" transaction, which for this purpose includes transactions in stock, as well as other forms of publicly-traded property. Accordingly, a "cash and carry," as that term traditionally is used in the commodities markets, and a "conversion," as that term traditionally is used in the equity markets, will be treated as conversion transactions, assuming (as is likely) that they constitute time value of money transactions for this purpose. The Bill, unlike the Administration proposal on which it is based, does not specifically include qualified covered calls within the definition of an applicable straddle. As these calls are not time value of money transactions, exclusion of qualified covered calls from Section 1258 is appropriate.[17]

The first broader category includes any time value of money transaction that is "marketed or sold as producing capital gains."[18] The Ways and Means Explanation narrows the scope of

---

[17] Because qualified covered calls are not conversion transactions, we are puzzled why a qualified covered call is presented in the Ways and Means Explanation, at 639, as an illustration of the taxpayer's net investment. A more relevant example would illustrate the net investment under arrangements that did constitute a conversion transaction.

[18] One interesting application of this rule may be to recharacterize as ordinary income short-term capital gain realized by holders of shares in certain mutual funds that invest primarily in short-term money-market investments and that pay dividends only once a year. Although typically not stated in the prospectus for such a fund, the annual dividend payout is understood by market professionals to provide an opportunity for the holder to redeem its stock shortly before the dividend date, thereby converting what otherwise would be ordinary dividend income into short-term capital gain. If investments in these mutual funds were regarded as marketed or sold as producing capital gain, that capital gain arguably will be subject to recharacterization under Section 1258, because an investor's expected net return from an investment in the fund by definition is attributable (in light of the fund's investment policy) to the time value of money. Accordingly, Section 1258 apparently will apply notwithstanding the fact that the purpose of the transaction presumably is capital loss utilization rather than an attempt to benefit from a tax rate differential.

It should be noted that the transaction described above is premised upon the availability of equalization accounting, which permits a regulated investment company (a "RIC") to treat amounts paid to redeeming shareholders as RIC income distributed to those shareholders for purposes of determining whether the RIC has distributed 90 percent of its net income for the taxable year. See Revenue Ruling 55-416, 1955-2 C. B. 416. Under current law, the redeeming shareholder does not treat the equalization amount as ordinary income. The revocation of Revenue Ruling 55-416, or (preferably) the amendment of Section 302 to characterize gain realized by a shareholder as ordinary income to the extent of the equalization payment, would eliminate the tax advantage

this category by providing that the transaction must be "marketed or sold to the taxpayer on the basis that it would have the economic characteristics of a loan but the interest-like return would be taxed as capital gain."[19] Even as narrowed, the provision raises serious questions about the appropriateness of basing tax results on the manner in which a particular investment is marketed.

Moreover, technical difficulties arise in applying the marketing test. First, this category conceivably could include time value of money transactions marketed to a customer in which the recognition of capital gain plays some part, even if the conversion of ordinary income into capital gain is not the principal purpose of the transaction. Second, the use of the phrase "to the taxpayer" suggests that a transaction marketed by A to B, C, and D would not fall within the scope of this category as to E. It is unclear whether the transaction falls within the scope of this category if, after A's marketing, E enters into the transaction with F. It is also unclear how directed the marketing effort must be, for example, whether entering into a transaction with X on the basis of a newspaper article by Y would bring the transaction within the scope of this category.

Section 1258 defines a second class of conversion transactions as any time value of money transaction specified in future Treasury regulations, which means that, depending on how the Service applies this grant of authority, the scope of Section 1258 could be very extensive. The Committee believes that it is appropriate for such regulations to apply as of the effective date of the Bill only with respect to specified transactions, and otherwise to apply with prospective effect only.[20]

b. Amount of Capital Gain Recharacterized As Ordinary Income. Under Section 1258, capital gain derived from a conversion transaction generally will be recharacterized as ordinary income to the extent of the lesser of (i) an imputed interest rate on the taxpayer's net investment in the conversion transaction or (ii) the taxpayer's total gain from the transaction. Thus, Section 1258 changes the character of, but not

---

of these arrangements, without introducing the complications of Section 1258.

[19] Ways and Means Explanation at 200.

[20] This approach was adopted in 1984 with respect to the expansion of section 1092 at that time to include a broader range of stock-based straddles, and has been implemented in proposed regulations. See Staff of the Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984. at 309 (Comm. Print 1984); Proposed Regulation Section 1.1092(d)-2.

the total amount of gain arising from, a transaction within its scope, except with respect to built-in loss property, as discussed below.

Interest that is imputed to a conversion transaction is deemed to accrue at a rate equal to 120 percent of the applicable Federal rate ("AFR") for a bond of the same maturity, or, in the case of a conversion transaction of indeterminate maturity, the short-term AFR. Section 1258 thus adopts a bright-line assumption as to the amount of income from a conversion transaction that is attributable to the time value of money. The result, however, is that in a transaction in which (i) the locked-in gain is less than 120 percent of the AFR, and (ii) appreciated property is disposed of in the transaction, gain attributable to market appreciation may be recharacterized as ordinary income.

To prevent double-counting under Section 1258, gain from a conversion transaction that otherwise would be recharacterized as ordinary income is not so recharacterized to the extent that the taxpayer has previously realized ordinary income under Section 1258 by reason of any prior disposition of property held as part of the same conversion transaction, or under regulations, by amounts capitalized under Section 263(g), ordinary income received, or otherwise. Reduction of the amount of gain subject to recharacterization by amounts capitalized under Section 263(g) is clearly necessary if Section 1258 is to recharacterize only amounts economically equivalent to interest income, and should be provided for without the need for regulations.[21] Similarly, failure to reduce the amount of capital gain subject to recharacterization under Section 1258 by interest or dividend income earned on property held as part of a conversion transaction would overstate the amount of ordinary income that should be deemed to arise from a conversion transaction.[22]

---

[21] The Ways and Means Explanation states that capital gain subject to recharacterization under Section 1258 "is subject to appropriate reduction" for amounts capitalized under Section 263(g) and ordinary income received, without reference to regulations. The Ways and Means Explanation provides an example of reduction of the amount of capital gain subject to "recharacterization under Section 1258 by amounts capitalized under Section 263(g).

[22] For an example of the reduction of capital gain subject to recharacterization under Section 1258 for ordinary income received, assume that X buys a non-dividend paying stock for $100 and sells it forward for $105, and that $4 of X's capital gain is recharacterized as ordinary income under Section 1258. Because the stock does not pay dividends, the forward price on this stock is attributable primarily to the time value of money. If X instead buys a stock that pays a $1 dividend during the period that X holds the stock, the forward price for that stock will be reduced by $1 to $104. Since X has already received $1 of ordinary income, and X's capital gain has been reduced by the

Alternatively, it should be made clear that regulations will be effective as of the effective date of the Bill with respect to such amounts. Additional regulatory authority is appropriate to deal with other adjustments.

The term “net investment in the transaction” includes the fair market value of any property that is part of the transaction, but is not otherwise defined in the statute. The Committee believes that the concept of “net investment” in the transaction will prove to be the most difficult technical ambiguity in applying proposed Section 1258. It appears from the Ways and Means Explanation that a taxpayer's net investment should be treated as analogous to funds loaned by the taxpayer. Accordingly, amounts that a taxpayer has committed to provide in the future, such as a forward contract to purchase property; are not treated as net investment until those funds are unavailable to invest in other ways. The Ways and Means Explanation clarifies that a taxpayer entering into a long futures contract offset by a short futures contract has no net investment in the transaction, as a result of which no part of the taxpayer's capital gain on the transaction is recharacterized as ordinary income.

It appears, therefore, that transactions in which the taxpayer does not advance funds (including funds advanced at a prior time to purchase property), such as a short sale, should not be treated as giving rise to net investment. The Ways and Means Explanation also clarifies that the source of funds, i.e., borrowing, is not relevant in determining a taxpayer's net investment, and that a taxpayer's net investment in a conversion transaction generally will be the aggregate amount invested by the taxpayer in the transaction less any amount received, such as an option premium, as consideration for entering into any position held as part of the transaction.[23]

Section 1258(d)(3) provides that the basis of property with an adjusted basis that exceeds its fair market value on the date that the property becomes part of a conversion transaction will be reduced to fair market value at that time. The built-in loss attributable to the excess of the old adjusted basis over

---

amount of that income, only $3 of X's $4 capital gain should be recharacterized as ordinary income under section 1258.

[23] The paragraph in the Ways and Means Explanation that appears to be intended to demonstrate the netting of amounts received and paid for purposes of calculation a taxpayer's net investment is difficult to understand, as the example given in the paragraph -- purchase of stock and writing a call -- is not a conversion transaction. As the final sentence of the paragraph states, the transaction is not one in which the taxpayer functions as a lender. Moreover, the transaction appears to be a qualified covered call transaction.

fair market value will be realized at the time the property is disposed of. The apparent intent of this provision is to treat a taxpayer that disposes of the property in a conversion transaction at a loss as realizing (i) gain subject to recharacterization under Section 1258 and (ii) a greater amount of loss.

For example, assume that X owns property with an adjusted basis of $150 and a fair market value of $100 at the time X enters into a conversion transaction under which X sells the property forward for $110. On the sale of the property, X would be treated as recognizing $10 of capital gain subject to recharacterization under Section 1258, and $50 of capital loss. This treatment will apply even if the property's value has risen to $110 at the time of sale, so that, absent Section 1258, X's $40 loss would accurately reflect X's economic loss from the property. We believe that, notwithstanding the conceptual purity of treating X as recognizing $10 of the ordinary income, it is inappropriate to require a taxpayer to recognize ordinary income on an asset that has given rise to an overall economic loss. We therefore recommend that this rule be eliminated.

Finally, one important issue in determining the amount of capital gain that is subject to recharacterization under Section 1258 that is not addressed in the statute or Ways and Means Explanation is the treatment of transactions in which one leg of the transactions is cash-settled. Some of the difficulties that can arise from partially cash-settled transactions are illustrated in the following examples.

Example (i). Assume that X purchases gold for $100 and enters into a forward contract to sell the gold for $105 one year later at a time when 120 percent of the short-term AFR equals 6 percent. When the forward contract is closed, the fair market value of the gold is $70. If X delivers the gold under the forward contract, X will recognize $5 of capital gain, which will be recharacterized as ordinary income under Section 1258.

Instead, X could choose to settle the forward contract with a cash payment of $35, computed by subtracting the fair market value of the gold at that time ($70) from the contract price ($105). In that event, X will recognize a $35 capital gain on the forward contract, of which $6 arguably is subject to recharacterization as ordinary income. The difficulty here is that the recharacterization rule of Section 1258(a), when applied to gain on one component of a conversion transaction, fails to take into account losses, whether realized or unrealized, that may have been incurred on other components of the transaction. In this example, X will have a loss of $30 on the gold itself,

whether realized or unrealized, and the amount of gain subject to recharacterization should not exceed the realized gain reduced by this loss.[24]

Example (ii). Assume that X enters into the contract described above, and that at the time that the forward contract is closed, the fair market value of the gold is $115. If X delivers the gold under the forward contract, X will recognize $5 of capital gain subject to recharacterization under Section 1258. If the forward contract is cash-settled, however, X will recognize a $10 capital loss on the forward contract, the recognition of which will be deferred under Section 1092. Because this transaction will not give rise to realized capital gain, it appears to fall outside the scope of Section 1258. X will have $15 of gain if it sells the gold, and a portion of this gain could be recharacterized under Section 1258, but further complications arise if the value of the gold declines before the sale but after the gold ceases to be part of a conversion transaction.

Example (iii). Assume that X enters into the contract described above, but that X's basis in the gold is $160. If the gold is delivered under the forward contract, the built-in loss rule of Section 1258(d)(3) would treat X as recognizing $5 of ordinary income and $60 of capital loss. If the forward contract is cash-settled, and the fair market value of the gold is $105 at the time the contract is closed, so that X realizes no gain or loss on the forward contract, the effect of the built-in loss rule is not clear. Under the basis adjustment provisions of the built-in loss rule, however, which provision applies "for purposes of applying this subtitle to such property for periods after such property becomes part of [a conversion] transaction" it appears that X's basis in the gold will be treated as $100 from that point forward.

c. Characterization of Capital Gain Treated as Ordinary Income. The Ways and Means Explanation states that recharacterized income will be treated as ordinary income, but not as interest. A footnote provides, however, that for purposes of the unrealized business taxable income and regulated investment company provisions of the Code, recharacterized income will continue to be treated as gains from the sale of property.

---

[24] Similarly, Regulation Section 1.1092-1T(a)(2) takes into account unrealized gains on other positions of a straddle in determining the amount of disallowed loss when a taxpayer disposes of less than all of the positions in a straddle.

The Ways and Means Explanation does not address the treatment of recharacterized income for purposes of the withholding tax provisions of the Code. Persons subject to withholding tax generally do not enter into conversion transactions for tax avoidance purposes, as neither capital gains nor, in the usual case, interest is subject to withholding tax. If recharacterized income is not explicitly treated for withholding tax purposes as gain from the sale of property or as interest, however, withholding agents -- who are personally liable for withholding taxes -- may withhold on such income on the grounds that income could be "fixed or determinable annual or periodic" income.

More generally, the Committee believes that it is inappropriate to treat recharacterized income as miscellaneous income that is not subject to any of the regimes of the Code applicable to defined categories of income. Recharacterized income should be treated either as capital gain for all purposes other than for purposes of sections 1, 11 and 1201, or in accordance with its economic substance and the purpose of Section 1258, as interest for all purposes of the Code.[25]

B. Market Discount Bonds

Under current law, the market discount rules generally provide that a bond purchased in the secondary market at a discount accrues market discount on a daily basis. The market discount is recognized as interest income either as it accrues, if the taxpayer so elects, or alternatively upon the disposition of the bond. If the taxpayer does not elect to accrue market discount income currently, the taxpayer's deductions for interest expense incurred to purchase or carry a market discount bond are deferred until the taxpayer sells or otherwise disposes of the bond in a taxable transaction. These rules do not apply to tax-exempt bonds. Market discount bonds issued on or before July 18, 1984, are not subject to the market discount accrual rule, but are subject to a special rule recharacterizing capital gain on

[25] Compare Section 14227 of the Bill, which applies an economic substance approach to determine whether certain payments are not treated as interest for purposes of the portfolio interest exemption from withholding tax. The characterization of recharacterized income as interest would be consistent with the treatment of capital loss from time value of money transactions as interest expense for purposes of determining a taxpayer's foreign source income under Regulation Section 1.861-9T(b). A taxpayer that enters into two offsetting conversion transactions, one of which would, in the absence of Section 1258, generate capital gain, and the other of which generates capital loss, should not be required to treat the capital loss as interest expense under Regulation Section 1.861-9T without being permitted to treat the (offsetting) recharacterized ordinary income as interest income.

the sale of the bond as ordinary income to the extent of any deferred interest expense.

The Bill repeals the transitional rule for market discount bonds issued prior to July 19, 1984. The repeal is effective for bonds purchased after April 30, 1993. Taxpayers currently holding such bonds will not be affected by the repeal, except insofar as the market price for these bonds in the secondary market may be adversely affected.

The Bill also subjects tax-exempt bonds to the market discount rules, including the recognition of such discount as interest income either currently or at disposition. Unlike actual interest on a tax-exempt bond, however, market discount on a tax-exempt bond will be includible as ordinary taxable income. In addition, the special rule for market discount bonds requiring the deferral of interest expense attributable to such bonds will not apply; instead, tax-exempt bonds with market discount will continue to be subject to the current provision of the Code requiring the disallowance of interest expense attributable to tax-exempt bonds.

The Committee supports the extension of the market discount rules to tax-exempt bonds, since there is no reason to distinguish the tax treatment of market discount on tax-exempt bonds from market discount on taxable bonds.

As to the repeal of the exemption for taxable bonds issued on or before July 18, 1984, the Committee notes that the Tax Section is generally opposed to the repeal of transition rules, because these rules typically reflect the reliance of taxpayers on provisions of prior law. In this instance, however, the proposed modification of the transition rule for market discount bonds would not directly affect existing holders of these bonds, but only those who purchased them after April 30, 1993. The only effect on existing holders is that the market value of their bonds would presumably decrease. While this is of some concern to us, we are aware that many changes in the tax law that are intended to operate with prospective effect (for example, a lengthening of the depreciation period for real estate) can affect market values of property. Moreover, the adverse effect on the value of market discount bonds may in this case simply offset the increase in the value of these bonds that might otherwise occur because of the increased rate differential between capital gains and ordinary income. Finally, the universe of pre-1984 bonds that trade at market discount in the current interest rate environment would appear to be small. The Committee believes that the proposed modification to the transition rule for these bonds is a reasonable approach to the problem of

windfall gains and continued bifurcation of market discount bonds between those that are covered by the market discount rule and those that are not, and is therefore not opposed to the proposal.

C. Stripped Preferred Stock

The Bill extends the principles of the original -issue discount rules currently applicable to stripped debt instruments to holders of certain stripped preferred stock. The Bill defines "stripped preferred stock" as stock that (i) is limited and preferred as to dividends and does not participate significantly in corporate growth, (ii) has a fixed redemption price, and (iii) as to which there has been a separation of ownership between the stock and any dividend not yet payable.

The holder of stripped preferred stock with a fixed redemption price in excess of the price at which the holder purchased the stock will be treated in a manner almost identical to the result that would have applied if the holder had acquired a bond bearing original issue discount in the amount of the excess. Accordingly, the holder will include in income each year an amount equal to that year's accrual of original issue discount income earned on a comparable original issue discount debt instrument. Those original issue discount accruals would apparently not be eligible for the 70 percent dividends received deduction in the hands of a corporate holder of stripped preferred stock, and also will not be treated as interest. As discussed above in Section III.A.3.c of this report, the Committee does not believe that it is appropriate to treat recharacterized income of this nature as miscellaneous income.

A shareholder who strips preferred stock and sells the right to future dividends will be treated as purchasing the stripped stock for an amount equal to the shareholder's adjusted basis in the stock. The Ways and Means Explanation expressly states that no implication is intended as to the allocation of basis by the creator of stripped preferred stock. The Ways and Means Explanation also disavows any inference as to the availability of the 70 percent dividends received deduction to a holder of dividends stripped from preferred stock, or the proper characterization of a purported sale of stripped dividend rights.

The Committee agrees that stripped preferred stock should not be permitted to be used to generate capital gains. The proposed provision fails to cover many closely related issues, and ideally, the proposal should address the tax treatment of stripped stock in a more comprehensive way. We are unaware, however, of any pressing non-tax business need to strip preferred stock, and we doubt that there will be any significant

transactions of this type if there is no tax advantage. Accordingly, the provision, despite its lack of comprehensiveness, is better than no provision at all, and we support its adoption pending the development of a broader set of rules.

When broader rules are developed, consistency with the rules applicable to stripped bonds would suggest that the sale of stripped dividend rights should be treated in the same manner as the issuance of an original issue discount bond by the seller of those rights, and that basis should be allocated in the same manner as under Section 1286. Such an approach might also treat the holder of the stripped dividend rights like the holder of a debt obligation. It is not clear to us, however, that the holder of a stripped share or a stripped dividend right should be treated like the holder of a debt obligation, in view of the risk that because of inadequate capital or inaction by the issuer's board of directors, the dividend might not be paid or the share might not be redeemed.

In any event, the holder of the stripped dividend rights should not be entitled to the dividends received deduction. As the holder of the stripped dividend rights would not own stock in the dividend-paying corporation, this treatment would be compatible both with the literal language of Section 316, which refers to the distribution of property by a corporation “to its shareholders,” and with the partial integration theory that underlies the dividends received deduction. It is less clear that denying the dividends received deduction to the holder of the stripped preferred stock is appropriate. One possible approach to this issue would be to permit the holder of the stripped preferred stock to claim the dividends received deduction for a taxable year with respect to the lesser of (i) the original issue discount inclusion for the year and (ii) the amount of dividends paid by the issuing corporation on the stock A simpler rule, however, would be simply to deny the dividends received deduction altogether. The proper resolution of these issues may depend in part on the evolving treatment of related matters, such as the taxation of equity swaps. Because the business need for stripped preferred stock is questionable, we doubt that great elaboration is needed here; a few simple rules should suffice.

NEW YORK STATE BAR ASSOCIATION
TAX SECTION

The Omnibus Budget Reconciliation Act of 1993: Provisions Affecting International Businesses

This report[1] summarizes our comments on certain provisions of The Omnibus Budget Reconciliation Act of 1993, H. R. 2264[2], that affect international businesses, specifically the limitation of the Section 936 credit,[3] the expansion of the earnings stripping rules, the exclusion of working capital from foreign base company shipping income, the modifications of the accuracy-related penalty in the case of transfer pricing adjustments, the denial of portfolio interest treatment for certain contingent interest, the authority to propose regulations dealing with conduit financings and the treatment of earnings invested in excess passive assets.

---

[1] This report was prepared by an hoc subcommittee of the U.S. Activities of Foreign Taxpayers and the Foreign Activities of U.S. Taxpayers Committees and was drafted by Cynthia G. Beerbower, Alan W. Granwell, Ayal Shenhav, Kenneth R. Silbergleit, Willard B. Taylor and Philip R. West. Helpful comments were received from Reuven S. Avi-Yonah, Peter C. Canellos, John A. Corry, Alan O. Dixler, Joseph J. Feit, Arnold J. Fries, Harold R. Handler, Michael Hirschfeld, Kenneth S. Kail, Richard 0. Loengard, Jr., Michael Loening, Michael L. Schler, Willys H. Schneider, Lawrence E. Shoenthal, David R. Sicular, Esta E. Stecher, Mary Sue Teplitz, Eugene L. Vogel and Philip R. Weingold.

[2] Cites to H.R. 2264 are to the House Ways and Means Committee version.

[3] Unless otherwise specified, all section references are to the Internal Revenue Code of 1986, as amended.

Summary

With respect to certain of the provisions, such as the limitation of the Section 936 credit and the denial of portfolio interest treatment for certain contingent interest, our comments should help to effectuate more fully the legislative intent With respect to other provisions, such as the expansion of the earnings stripping rules, the modifications of the accuracy related penalty and the authority to propose regulations dealing with conduit financings, we recommend changes to the provisions which, although perhaps not within the current legislative intent, would address specific concerns articulated below.

With respect to a third group of provisions, however, including the treatment of earnings invested in excess passive assets and the exclusion from foreign base company shipping income for working capital, we suggest elimination of the provisions. In our view, they are unsound from a tax policy perspective. We also believe, however, that if, contrary to our recommendations, these provisions are enacted, they should incorporate the alternative recommendations set forth below.

I. H.R. 2264 Section 14226, Limitation on Section 936 Credit.

Section 936 provides that a U.S. corporation meeting certain requirements that derives certain income from a U.S. possession is entitled to a credit against its U.S. tax liability on such income. The credit is provided whether or not any actual possession tax is paid on the income.

H. R. 2264 Section 14226 would impose two limitations on the Section 936 credit:

(i) The credit allowed against U.S. tax on business income would be limited to 60 percent of the "qualified wages" the U.S. corporation paid to its employees in the possession, and

(ii) The credit allowed on qualified possession source investment income ("QPSII") would be limited in cases where the corporation's assets that generate QPSII exceed 80 percent of its tangible business property in the possession.

Comments:[4]

1. If the proposal is enacted, wages should only count if they are paid or incurred in connection with the same trade or business that gives rise to the income against which the possession corporation seeks to apply the Section 936 credit.

There is an incentive in the proposed Section 936 legislation for highly profitable possession corporations to acquire low-profit, labor-intensive businesses in order to maximize the wage cap on the Section 936 credit. If a possession corporation can acquire a low-profit business with many employees, then more of the income of the profitable business can be sheltered from federal income taxation. We believe that such a tax-motivated rather than business-motivated incentive is inappropriate.

2. The definition of wages should include deferred compensation and other benefits not necessarily reflected on Form W-2.

[4] This report is intended to address specific aspects of the Section 936 proposal. No inference should be drawn as to our views on the merits of the proposal.

We suggest that the term “wages” be defined in a manner that does not discourage companies from providing the same level of benefits to possession corporation employees as provided to other comparable employees.

II. H.R. Section 14227. Modification to Limitation on Deduction for Certain Interest

H. R. 2264 Section 14227 amends Section 163(j) of the Code to (a) extend the earnings stripping rules to certain guaranteed third-party debt and (b) eliminate the “grandfather” for interest paid on debt incurred on or before July 10, 1989, or thereafter pursuant to a binding commitment that was then in effect.

Comments:

1. The definition of a guarantee should be limited to legally enforceable obligations.

Although H.R. 2264 Section 14227 refers to “guarantees”, the Ways and Means Committee Report says that a guarantee “includes an arrangement reflected in a 'comfort letter', regardless of whether the arrangement gives rise to a legally enforceable obligation”.[5]

A comfort letter is ordinarily no more than a statement of policy with respect to obligations of a subsidiary. If a comfort letter is a “guarantee” for purposes of Section 163(j), why shouldn't the statute also cover the same message, delivered

[5] See Staff of the Committee on Ways and Means, Fiscal Year 1994 Budget Reconciliation Recommendation W.M.C.R.; 103-11, 103d Cong. 1st Sess. (“House Ways and Means Committee Report”), at 249.

over the telephone, or a letter that simply acknowledges that the borrower is a subsidiary? It is conceivable that even loan document financial covenants regulating a subsidiary's transactions with its parent might be problematic. The inclusion of non-enforceable obligations in the definition of a guarantee is so vague, and so greatly expands the scope of the statute, that it has the potential to subject interest on all debt of a foreign controlled U.S. subsidiary to Section 163(j), even though none of the lenders have any enforceable rights against the foreign parent.

The sweeping references in the legislative history to contingent obligations and obligations to make capital contributions is also confusing. Suppose that the obligation is to contribute $50 to the capital of a subsidiary that has borrowed $150 from unrelated lenders and $50 from a related lender? Is the obligation a guarantee of each pro rata? Only of the debt from the unrelated lenders? While a guarantee should, of course, include anything that has the legal effect of a guarantee, the precise scope ought to be left to regulations and not dealt with by imprecise legislative history.

2. The provision should clarify what is intended by interest paid where the recipient would have been taxed on a “net basis”.

H.R. 2264 Section 14227(b) would amend Section 163(j)(6) to authorize regulations that could exclude interest on a guaranteed third-party debt from the definition of disqualified interest, if interest on the guaranteed third-party debt would have been taxed on a net basis had it been paid to the guarantor.

We question the purpose of this exclusion. It appears from the legislative history that the purpose is to carve out a case where the guarantee could not have been entered into to avoid the earnings stripping rule because the guarantor would have been taxed on directly-paid interest.[6] This raises several issues, as follows:

(a) First, there are obvious computational difficulties with an exception that is dependent on the existence of a purely hypothetical tax on hypothetical interest.

(b) Second, the circumstances under which interest paid to a U.S. branch of a foreign corporation will be treated as effectively connected are uncertain and involve difficult factual inquiries, such as determining which personnel evaluated the subsidiary's credit[7] -- to apply these rules to notional loans, as the legislative history requires, will be extremely difficult.

(c) Third, if the purpose is to delegate authority to carve out cases where the guarantee has no “bad” purpose, shouldn't it be more broadly phrased? Isn't the case for excluding interest on guaranteed debt just as persuasive, for example, in a case where it can be demonstrated that sole purpose of the guarantee was to reduce the rate of interest paid to the third party lender as in a case where the interest, if paid to the foreign guarantor, would have been taxed?

3. The amendment of Section 163 (i) emphasizes the need for regulations.

---

[6] See House Ways and Means Committee Report at 248-49.

[7] See Rev. Rul. 86-154 (Situation 2).

The extension of Section 163(j) to interest on guaranteed third-party debt makes it particularly important to have final regulations under that Section, including regulations that deal with so-called "interest equivalents" and guarantees of instruments that create "interest equivalents".[8]

4. Borrowings from a controlled subsidiary should be treated the same as borrowings guaranteed by the controlled subsidiary.

H. R. 2264 Section 14227(b) excludes interest on guaranteed debt if the guarantor is a controlled subsidiary of the borrower, thus creating a discontinuity between the treatment of borrowings from a foreign subsidiary (which may subject the interest to the earnings stripping rules) and third party borrowings that are guaranteed by a foreign subsidiary.

We believe that the rule should be the same in each case -- among other things, the distinction between a guarantee and a loan is uncertain. For example, if foreign subsidiary X deposits funds with unrelated bank Y as security for Y's loan to X's U.S. parent, Z, X has made a loan to Z under the Internal Revenue Service's back-to-back loan rulings but just as clearly it would appear to be a guarantee within the meaning of H.R. 2264 Section 14227(b).

5. The provision should apply prospectively.

As enacted, Section 163(j) does not apply to interest on debt issued before July 10, 1989 (or thereafter pursuant to a

[8] The treatment of interest equivalents was reserved in the regulations that were proposed in June of 1991.

commitment binding on that date) and, while the potential for avoiding the earnings stripping rules by the use of guarantees was recognized at that time,[9] the earnings stripping rules do not apply to interest on guaranteed third-party debt except to the extent provided in the regulations that are to be issued on a prospective basis. Both the July 10, 1989 “grandfather” for related party debt and the decision to deal with interest on guaranteed third-party debt only on a prospective basis were conscious, legislative decisions. No honest policy, other than the collection of revenue, can justify now reversing those decisions. With that background, we think it is unfair either to eliminate the July 10, 1989 “grandfather” for debt issued to related persons or retroactively to subject interest on guaranteed third-party debt to the earnings stripping rules.

III. H.R. 2264 Section 14235(b). Exclusion from Foreign Base Shipping Income for Working Capital

H. R. 2264 Section 14235(b) would amend the foreign base company shipping income provisions by excluding from foreign base company shipping income (“shipping income”) any dividend or interest income that is foreign personal holding company income (as defined in Section 954(c)).[10] This provision would be effective for taxable years beginning after December 31, 1992.

The Committee Report states that the reason for this change is to treat passive income derived in connection with shipping operations consistently with other passive income for

---

[9] See H.R. Conf. Rep. No. 386, 101st Cong., 1st Sess. (1989) at 567.

[10] In this discussion, the Committee is not commenting on the application of the bill to oil and gas income.

foreign tax credit purposes.[11] Such consistency requires placing passive dividend and interest income related to shipping operations in the passive category for foreign tax credit limitations purposes. Segregating passive income for foreign tax credit limitation purposes is designed to prevent the cross-crediting of foreign taxes.

Comments:

1. Cross-crediting of shipping income is not a significant problem.

Cross-crediting nay occur where high-taxed income and low-taxed income are in the same foreign tax credit limitation category. Neither shipping income nor dividend and interest income related to shipping operations is generally subject to high foreign taxes. Therefore, the policy reason that ostensibly might support the proposal as applied to oil and gas income that generally is subject to high foreign taxes does not support the proposal as applied to shipping income.

2. The proposal would inappropriately eliminate the benefits of Section 954(b)(6).

Since at least 1974, Congress has recognized that the shipping industry was (and continues to be) a highly competitive and capital intensive industry.[12] Therefore, as described below, Congress felt it appropriate to develop mechanisms to permit shipping businesses to accumulate and move cash without the current imposition of U.S. tax.

---

[11] See House Ways and Means Committee Report at 277

[12] See Report of the House ways and Means Committee on H.R. 17488, Energy Tax and Individual Relief Bill of 1974, No. 93-1502, 93d Cong., 2d Sess., pp. 135-136.

In 1975, Congress modified subpart F by enacting the foreign base company shipping income provisions to cause shipping income to be treated as subpart F income to the extent that it is not reinvested in qualified shipping assets. The reinvestment exclusion was repealed in 1986, and shipping income earned thereafter has been currently taxed, regardless of whether it is reinvested in qualified shipping assets.

Pursuant to Section 954(b)(6), however, earnings accumulated prior to 1987 that were attributable to shipping income continue to be shielded from tax, even if distributed within a chain.[13] The purpose of this rule is to permit shipping profits to be moved around in chains of shipping corporations without current imposition of subpart F taxation. An effect of characterizing dividend income as foreign personal holding company income would be to eliminate the benefits of Section 954(b)(6). Therefore, earnings attributable to shipping operations that have not been taxed no longer could be distributed tax-free to an upper-tier controlled foreign corporation. As such, the proposed amendment would make it more expensive than was the case prior to the amendment to move cash within a shipping group and would eliminate the last vestige of flexibility in the movement of cash among members.

We understand that elimination of the Section 954(b)(6) rule may not have been an intended consequence of the proposal A review of the current broad language of the proposal, however, does not permit any other interpretation. Therefore, although we

[13] Under Section 954(b)(6), income of a corporation which is shipping income is not considered as foreign base company income under any other provision of Section 954 and, if distributed through a chain of ownership, is not included in foreign base company income of another controlled foreign corporation in such chain.

believe, as stated above, that the cross-crediting policy behind the proposal is not justifiable and, therefore, the proposal should not be enacted, if the proposal is enacted, then it should be modified so that the Section 954(b)(6) rule is retained.

3. The proposal should not be retroactive.

Shipping companies may already have made 1993 distributions in reliance on Section 954(b)(6). Therefore, and based on general tax policy grounds, we believe that it is inappropriate to make the proposal retroactive.

IV. H.R. 2264 Section 14236. Transfer Pricing Initiative

Under Sections 6662(e)(1) and 6662(h), Section 482-related penalties can be imposed either if "net Section 482 transfer price adjustments" to taxable income[14] exceed prescribed absolute dollar thresholds (the "Dollar Adjustment Tests") or if prices for property or services claimed on any return are greater than, or less than prescribed percentages of the amount determined to be correct (the "Price Percentage Tests"). H.R. 2264 Section 14236 (i) reduces the thresholds currently applicable under the Dollar Adjustment Tests and (ii) prescribes standards for application of the "reasonable cause and good faith" exclusion applicable in determining whether such tests have been met.[15]

---

[14] The term "net Section 482 transfer price adjustment" means, with respect to any taxable year, the net increase in taxable income for the taxable year resulting from adjustments under Section 482 in the price for any property or services. S 6662(e)(3)(A).

[15] One requirement for invoking the reasonable cause and good faith exclusion is that the taxpayer's use of its chosen transfer pricing method must have been reasonable. The legislative history to the proposal provides as follows with respect to the reasonableness requirement: "In order for the application of the method to have been reasonable, the committee intends that any procedural or other

Comments:

1. The proposed penalty thresholds are too low.

The proposal to lower the transfer pricing substantial valuation misstatement penalty threshold to $5 million or 10 percent of gross receipts (and to lower the gross valuation misstatement threshold to $20 million or 20 percent of gross receipts) is premised on the apparent perception that the $10 million threshold is too high.[16] It has also been reported that the Internal Revenue Service sought a lower threshold because a proposed adjustment at the higher level frequently cannot be sustained.[17]

We believe that the latter reason is an insufficient basis for altering a penalty threshold. Moreover, the proposed lowering of the threshold could more easily cause a corporation to be subject to these severe penalties even though the actual transfer pricing adjustment is quite modest. Therefore, the penalties could apply to corporations that have no intention of trying to avoid the transfer pricing provisions. We believe that a penalty provision should be applicable only where there is some level of significant misconduct by the taxpayer. Accordingly, we think that if this lower dollar threshold were to be adopted,

---

requirements imposed under the regulations must have been observed." House Ways and Means Committee Report at 284. "The committee intends that the application of any method would not be considered reasonable if the taxpayer became aware prior to filing its tax return that such application more likely than not did not result in a clear reflection of income." Id. at 285.

16 Id. at 282.

17 See Turro, Panels Ponder Foreign Tax Issues, 59 Tax Notes 877, 878 (May 17, 1993).

then there also should be some additional threshold which, if satisfied, would serve as a presumption of misconduct. The additional threshold might require that the transfer pricing adjustment exceed, at a minimumx to ensure that the provision does not entrap taxpayers who did not intend to avoid the transfer pricing rules.

2. The rule that all procedural and other requirements must be met should be modified.

We are concerned about the statement contained in the Ways and Means Committee Report,[18] that all procedural and other requirements of the regulations must have been observed. We suggest that this is an extremely onerous burden because of the numerous adjustments that may have to be made to reflect differences in functions or risks. It is possible that taxpayers in good faith may believe that all of the required adjustments had been made but the Internal Revenue Service believes additional adjustments are required. In this case, taxpayers may be treated as utilizing an "other method". If so, they ostensibly would have to satisfy both the procedural and substantive rules of the "other method" methodology.[19] This would not be possible after the fact because of the requirements of the aforementioned sections. Moreover, under the proposed statutory language relating to net Section 482 transfer price adjustments when "other methods" are used, the taxpayer would not be able to comply with the onerous preconditions for satisfying the statutory reasonable cause and good faith exclusion. Thus, it is not clear in this case how a taxpayer could defend its position under an "other method" approach. The effect of this proposed

[18] House Ways and Means Committee Report at 284.

[19] See Temp. Reg. §S 1.482-3T(e)(2) & 1.482-4T(d)(2).

rigid statutory approach is that the onerous requirements for avoiding a penalty will have an impact on the substantive rules of Section 482. In our view, this result is wholly inappropriate.

We suggest that as long as there has been substantial compliance in good faith with all the conditions for use of a particular method, taxpayers will be deemed to have satisfied this particular condition.

3 The requirement that documentation roust be sufficient at the time the tax_ return is filed should be modified.

We believe that if contemporaneous documentation would pass muster when completed, taxpayers should not have the additional obligation of revisiting that documentation for changed circumstances at the time the return is filed. The requirement is simply too onerous and in no way illuminating on the question of who are the “bad actors” deserving of penalties.

Second, we are concerned about how the requirements of the proposal relate to the compensating adjustment rule of the temporary regulations. The regulatory requirement is relevant because, as stated above, the Committee intends that the regulatory requirements must have been observed for the application of a method to be viewed as reasonable. Our concern arises in cases where a taxpayer has not entered into written documentation sufficient to satisfy the compensating adjustment provisions of the temporary regulations. In this regard, we would suggest that if critical assumptions change after the taxable year, taxpayers be able to make compensating adjustments on their return irrespective of whether the required documentation has been executed.

4. The 30-day period should be extended.

We believe that the 30-day period for disclosure to the Service is too short. Instead, we suggest that the time period employed in the Section 6038A regulations with respect to non-U.S. record production requirements,[20] i.e., 60 days plus a "good cause" extension, be adopted. We think that the good cause provision is essential and the 60-day time frame more reasonable.

5. The legislative history should not equivocate on the utility of Advanced Pricing Agreements (APAs).

The proposal's legislative history provides as follows:

> Such a method may be embodied, for-example, in an advance pricing agreement. If the taxpayer's documentation establishes the prior agreement of the Service, establishes that the taxpayer applied the agreed method reasonably and consistently with its prior application, and establishes that the facts and circumstances surrounding the use of the method have not materially changed since the time of the agreement, the Committee anticipates that, for purposes of applying the penalty, the taxpayer generally will be treated as having established adequate justification for failure to use a specified method and its use instead of the unspecified method. House Ways and Means Committee Report at 285 (emphasis added).

Revenue Procedure 91-22,[21] (the APA procedure), contains the following statement with respect to the legal effect of an APA: "If the taxpayer complies with the terms and conditions of the APA, the Service will regard the results of applying the TPM as satisfying the arm's length standard, and, except as provided

---

[20] Reg. § 1.6038A-3(f)(2)4(4).

[21] 1991-1 C.B. 526.

in subsection 10.03 of this revenue procedure, will not contest the application of the TPM to the subject matter of the APA."

Based on the foregoing, we believe that an APA should be a complete defense to a Section 482 allocation and to resultant penalties, provided the taxpayer complies with the terms and conditions of an APA and that the facts and circumstances surrounding the use of the method have not materially changed. We do not understand the reason for the equivocation in the House Ways and Means Committee Report, especially since we understand that taxpayers are to be encouraged to use the APA process.

6. The proposal should allow for pricing analyses on an aggregate or product line basis.

We suggest that the Section 482 penalty provisions be considered in a practical fashion. For example, if a taxpayer has many different products, we would hope that the taxpayer could perform a pricing analysis on a grouping basis rather than on an individual product basis. This type of change would permit a taxpayer better to identify and document a transfer pricing methodology.

V. H.R. 2264 Section 14237. Denial of Portfolio Interest Exemption for Contingent Interest

Under current law, the United States generally imposes a 30 percent withholding tax on the gross amount of interest income derived from U.S. sources and paid to a nonresident alien individual or foreign corporation. The 30 percent withholding tax does not apply, however, to "portfolio interest." Subject to certain exceptions (e.g., interest paid to related persons), the

term “portfolio interest” includes any type of interest income, provided certain procedural requirements are satisfied.

Under current law a payment may qualify as interest to which the portfolio interest exemption applies even if the instrument on which the payment is made provides the holder with significant rights to participate in the profits or cash flow of the issuer, so long as the instrument constitutes indebtedness for U.S. federal income tax purposes. For example, a domestic corporation that owns commercial real estate might issue to a foreign investor a debt instrument that pays a fixed amount of annual interest plus additional amounts equal to a percentage of the rental income derived from the real estate.

H. R. 2264 Section 14237 would limit the availability of the portfolio interest exemption so that certain types of contingent interest would become subject to withholding tax. Generally (and subject to the important qualifications described in the next paragraph), the term “portfolio interest” would not include contingent interest payments determined with reference to (i) any gross or net income or cash flow of the borrower or a related person; (ii) any change in the value of property owned by the borrower or a related person; or (iii) any dividends, partnership distributions or similar payments made by the borrower or a related person.[22]

The provision provides for several exceptions. Under these exceptions, interest payments subject to contingencies would continue to qualify for the portfolio interest exemption if (i) the contingencies affect solely the timing, rather than the

[22] The Treasury Department also would be granted regulatory authority to include other types of contingent interest where necessary or appropriate to prevent tax avoidance.

amount, of interest or principal payments; (ii) the interest is contingent solely because it is paid in respect of nonrecourse or limited recourse indebtedness; (iii) the interest is determined by reference to any other amount of interest that is not itself contingent; (iv) the amount of interest correlates with the income, cash flow or value of the property of the borrower merely because the borrower enters into a hedging transaction to reduce the risk of interest rate or currency fluctuations with respect to such interest; or (v) the amount of interest is determined with reference to the value or yield of actively traded property, such as commodities or publicly-traded stock, or an index reflecting the value or yield of such property (other than (A) an interest in real property that would be subject to the rules of the Foreign Investment in Real Property Tax Act of 1982 ("FIRPTA"), (B) a debt instrument paying contingent interest that is itself subject to the restrictions of this provision or (C) stock or other property that represents a beneficial interest in the borrower or a related person).

Comments:

1. The proposal should be coordinated with Section 897.

The holder of a contingent interest obligation with respect to real property generally is treated as holding an interest other than solely as a creditor and, therefore, as holding a U.S. real property interest under Section 897. Under current law, if such a holder is not a U.S. person, that holder, notwithstanding its foreign status, will be subject to tax under Section 897 on a disposition of the obligation, but will not be subject to tax as long as the obligation is held to maturity and an interest payment is received on the debt. One purpose of the

proposal is to conform the tax treatment applicable to both situations.[23]

There are no detailed rules, however, for determining whether an interest is an interest solely as a creditor for purposes of Section 897. We recommend, therefore, that Section 897 be amended (or that the Secretary be directed to provide regulations) to coordinate Section 897 with new Section 871(h)(4). If, after enactment of the new provision, the interest on an obligation would still qualify for the portfolio interest exemption, the holder should not be taxable under Section 897 upon a sale of the obligation prior to maturity.

2. The proposal should provide clarification regarding debt with minimum non-contingent interest rate.

The disqualification from the portfolio interest exemption applies only to the contingent portion of the interest If the interest rate on a note is stated in terms of the greater of either of two amounts (e.g., 6% of the principal amount or 10% of gross rents), only one of which is a contingent amount, it should be clarified that only the excess of the contingent amount, if any, over the minimum fixed amount would be subject to disqualification.

3. Regulations should be prospective.

Proposed Code Section 871(h)(4)(A)(ii) would authorize the Secretary to identify by regulation other types of contingent interest not specifically set forth in the statute that would not

[23] See House Ways & Means Committee Report at 287.

qualify for the portfolio interest exemption. We urge that any such regulations be applied prospectively only.

4. The proposal should clarify treatment of an interest rate tied to an index of interest rates.

While an interest rate based on a formula tied to an index of interest rates (such as LIBOR plus one) would appear not to be included in the definition of contingent interest set forth in the statute, in light of the broad discretion provided to the Secretary, we suggest that the statute specifically provide that such a formula interest rate qualifies for the portfolio interest exemption.

5. The exceptions should be clarified.

Proposed Code Sections 871(h)(4)(C)(i), (ii) and (iv) provide that interest will not be excluded from the definition of portfolio interest "solely" by reason of the facts described in each clause. Use of the word "solely" gives us concern and we suggest that the word be deleted. Our concern is that a taxpayer that qualifies for two or more of such exceptions may not qualify solely by reason of any one exception. For example, if interest in excess of cash flow is permitted to accrue until maturity of the note, and if the note is a nonrecourse obligation, there may be a question as to whether the taxpayer would qualify solely under exception (i) or exception (ii).

In addition, we recommend that the hedging transaction exception extend to all hedging transactions, not just those entered into to reduce interest rate or currency fluctuations.

7. The proposal should clarify the estate tax treatment of contingent debt and make conforming amendments.

Section 2105(b)(3) provides an estate tax exemption to nonresidents for debt obligations if “any interest thereon” would be eligible for the portfolio interest exemption. Accordingly, completely contingent interest obligations may no longer qualify for the estate tax exemption. Is this intended? If an obligation calls for contingent and non-contingent interest, however, it appears that it will qualify in full for the estate tax exemption (since Section 2105(b)(3) refers to “any interest” not “all interest”). Is this intended or should there be a proration? In any event, a conforming amendment needs to be made to Section 2105(b)(3). The cross-reference to Section 871(h)(4) should be changed to Section 871(h)(5).

VI. H. R. 2264 Section 1423-8. Regulations Dealing with Conduit Arrangements

H. R. 2264 Section 14238 will authorize the issuance of regulations that nay recharacterize multiple party financing transactions as transactions directly between any two or more of the participants if necessary to prevent the avoidance of tax

Comments:

1. A uniform set of rules should be applied in this area.

Published rulings have previously treated so-called back-to-back loans as direct loans for purposes of the rules relating to the withholding tax on interest and investments by controlled foreign corporations in United States property. The

legislative history of Section 163(j) indicates that those rules apply for purposes of that Section.[24] We have previously commented that the published rulings are not altogether consistent and have recommended that consideration be given to a single uniform set of rules.[25] We therefore support the issuance of regulations that will deal on a comprehensive and consistent basis with back-to-back loans.

2. Any regulations under Section 7701(1) should rationalize the rules and should take into account tax treaty obligations.

The Ways and Means Committee Report, however, seems to envision regulations that may do no more than endorse the position taken by the Internal Revenue Service in published and unpublished rulings -- while it provides that the regulations need not follow those rulings, it describes those rulings as "appropriately ignor[ing] the conduit entities and properly recharacteriz[ing] the transactions described therein".[26] It seems to us that this misses the point -- the rulings are inconsistent and in important respects unclear,[27] and this should be recognized.

In addition, the need to coordinate any regulations with U.S. obligations under treaties that already include "treaty-shopping" articles should be recognized -- will "conduit"

---

[24] See H.R. Rep. Ho. 247, 101st Cong., 1st Sess. (1989) at 1248.

[25] See NYSBA, Report on Section 163(j) of the Internal Revenue Code, reprinted in 47 Tax Notes Number 12, June 18, 1990 at 1495, 1511-12.

[26] See House Ways and Means Committee Report at 291

[27] Rev. Rul. 84-152, for example, could be read to imply that any corporation is a conduit for its lenders if the corporation did not have, without regard to any borrowing, enough liquidity to make the loan in question.

principles set out in the regulations apply, for example, if interest on a loan from a German corporation was entitled to treaty benefits under the new U.S.-German tax treaty?

3. The regulations should be prospective only.

The regulatory grant of authority is very broad. For this reason, regulations issued pursuant to Section 7701(1) in our view should be prospective among other reasons, in order to permit appropriate comments. Moreover, such regulations only should apply to multiple party financing arrangements entered into after the date on which regulations are issued. The treatment of prior arrangements should be determined under existing law. In this connection, as noted above, we do not think it is appropriate for the legislative history[28] simply to endorse the Internal Revenue Service's statements of its position (including the conclusions reached in technical advice memorandum), given the ambiguity and uncertainty as to how those rulings apply. For example, some may view the rulings simply as providing a framework within which to analyze a given set of facts, and not as providing substantive guidance as to what the results should be.

VII. H.R. 2264 Section 14231. Earnings Invested in Excess Passive Assets

H. R. 2264 Section 14231 would require a U.S. shareholder of a controlled foreign corporation (“CFC”) to include in its income annually the lesser of (i) its pro rata share of the CFC's excess passive assets, as adjusted, or (ii) its pro rata share of the CFC's current and accumulated earnings

[28] See House Ways and Means Committee Report at 291.

and profits, as adjusted. The term “excess passive assets” is defined to mean, for any taxable year, the excess of (i) the average of the adjusted basis of passive assets held by the CFC at the end of each quarter in the taxable year over (ii) 25 percent of the average of the adjusted basis of total assets held by the CFC at the end of each quarter in the taxable year. The term “passive assets” is defined generally as in the passive foreign investment company (“PFIC”) rules.

The effect of the proposal would be to require U.S. shareholders of a CFC to include in their income the current and accumulated earnings and profits of the CFC, to the extent of the CFC's excess passive assets, even if those earnings and profits were earned in a prior taxable year when they were not required to be included in any U.S. person's income and even if they are now invested in illiquid assets.

Current law generally allows U.S. shareholders of a CFC that is not a PFIC to defer tax on the CFC's active business income. In view of the Administration and the House Ways and Means Committee, however, neither the CFC nor the PFIC regimes sufficiently restrict the benefits of deferral in the case of CFCs that accumulate excessive quantities of earnings and profits without reinvesting them in active business assets.[29]

---

[29] See House Ways and Means Committee Report at 254. In his testimony before the Senate Finance Committee, Deputy Assistant Treasury Secretary Sessions stated in support of the proposal that many CFCs are able to defer tax indefinitely on accumulated income by managing their income and assets so as to avoid exceeding the PFIC thresholds. Statement of Samuel Sessions, Deputy Assistant Treasury Secretary for Tax Policy, Before Senate Finance Committee, April 27, 1993 (“Sessions Statement”), reprinted Bureau of National Affairs, Daily Tax Report of April 28, 1993, at L-l, et seq. Deputy Assistant Secretary Sessions testified that without the proposal, a significant incentive that is difficult to justify encourages CFCs to hold earnings in passive investments offshore rather than repatriate them or invest them in active businesses. See id. at L-3.

Comments:

1. The proposal does not advance the policy objectives of increasing U.S. investment vis-a-vis foreign investment or of enhancing competitiveness of U.S. businesses.

Deputy Assistant Secretary Sessions opened his testimony to the Senate Finance Committee by stating that the Administration's proposals are designed, in part, to eliminate tax incentives that favor operation abroad rather than operation in the United States. The proposal under consideration encourages investment outside the U.S., however, in cases in which repatriation would involve a greater tax cost to the U.S. shareholders of the CFC than reinvestment in an active business (because, for example, a withholding tax applies to repatriated earnings for which a full foreign tax credit is not available). To illustrate, if a CFC had sufficient passive assets so as potentially to be subject to the new anti-deferral rules and the U.S. multinational needed to increase capacity, it might be more inclined, to the extent that tax considerations played a role in the decision, to have the CFC use its passive assets to build a new manufacturing plant in the country of the CFC's incorporation, rather than in the United States so as to avoid the anti-deferral rules.

2. The proposal is too complex.

The proposal would greatly increase the complexity of the Code, while raising a modest amount of revenue. It incorporates parts of the Subpart F and PFIC rules, but these do not mesh well; Subpart F is applied on a company-by-company basis, while the PFIC rules apply a look-through test. Thus, the proposal starts off using the Subpart F concept of looking at

each CFC separately, but then adopts the PFIC look-through rule, so that a parent company would be treated as owning a pro rata portion of the assets of each subsidiary in which it owns 25% or more, directly or indirectly. However, as one proceeds down the chain of subsidiaries, each of those subsidiaries that are CFCs would be tested separately, together only with its subsidiaries (regardless of whether they are CFCs).

While we believe it is critical that the proposal not apply purely on a company-by-company basis since that would produce harsh and inconsistent results, we believe further thought needs to be given to the proposed look-through rules. One problem is that the proposal seems to cause double counting and inconsistent results in many cases. For example, if A owns all of the stock of B, which owns all of the stock of c, and A owns only $100 of passive assets, B owns only $500 of active assets and C owns only $100 of passive assets, there would be a deemed distribution of $25 from A (200-(25% x 700)) and $75 from C (100-25). There would be no deemed distribution from B. In contrast, if A owns C and C owns B, the total amount deemed distributed would be only $25 and only from A. One solution would be to make all determinations on a consolidated basis using the S 1504(a) standard without regard to § 1504(b)(3) (which, in the example given, would also produce a result of $25), although it would probably make sense in this context to follow the proposed rule in the bill and also pro rate the assets of subsidiaries which are less than 80% owned. Under such a principle, the provision would only apply once to each such group as if it were a single corporation, and would not apply separately to the subsidiaries in a group.

However, whether the current proposed rules are adopted or the consolidated rules are used, there must be some provisions

for determining the source of a deemed dividend where more than one company in a group of companies is involved in the calculation. One possible solution is to have foreign tax credits determined on a consolidated basis for the relevant companies and, therefore, the source of the deemed dividend, as between the various companies involved, would be immaterial. However, application of such a rule raises significant policy issues of its own, since under certain circumstances such a rule could cause taxpayers' foreign tax credits to be greater than they would be in its absence. Furthermore, it is difficult to see how the foreign tax credit basket rules are to be applied if either a look-through or a consolidation provision were adopted.

Unfortunately, the complexities do not end there. As proposed, the provision seems to require a determination of a foreign company's earnings and profits going back to ancient history; in many cases, especially in the case of acquired foreign companies, it may be absolutely impossible to make that determination, with records lost due to deliberate destruction as well as wars and other calamities. Even the basis of foreign assets may not easily be determined, especially if that determination has to be made using U.S. tax standards. While in the past the basis of, for example, a plant in France used to manufacture products might have had some U.S. tax impact if the income of that company had to be determined for U.S. tax purposes (e.g., for purposes of determining foreign tax credits), ascertaining the tax basis of all property owned abroad, such as real estate, frequently will be impossible.

Finally, we note that the proposal contains a rule directing the Treasury to issue regulations “to prevent the avoidance of this section through reorganizations or otherwise.” It is difficult to anticipate the scope of such regulations,

especially if consolidation is not the operating principle. As noted above, if the provision remains as proposed, its results can be so arbitrary that almost every transfer of assets, no matter how justified by business considerations, will have to be undertaken with its consequences under this provision in mind. Is it intended that the Treasury be able to recast such transactions to increase the percentage of passive assets? It appears that, in the context of a statutory provision with as broad a purpose as this, such in ill defined grant of authority is inappropriate.

We have recently objected to the staggering complexity of the PFIC rules.[30] As stated above, we believe this proposal represents an inappropriate further complication of the international tax regime. We would encourage instead a decision either to eliminate deferral completely or abandon the exceptions to deferral. If, as Deputy Assistant Secretary Sessions has implied,[31] there is a problem with CFCs managing their income and assets so as to avoid PFIC status, that problem could be addressed simply by revising the PFIC thresholds, although we do not advocate this route. We surmise that it was not taken by the Administration and the House because, as discussed in the following paragraph, it would be inappropriate to bring within the PFIC rules the CFCs that will be affected by the proposal.

3. The proposal goes further than is necessary to accomplish the policy objective of restricting -excessive" accumulations.

---

30 See Letter Dated April 27, 1993 from Peter Canellos, Chairman, New York State Bar Association Tax Section to Harry Gutman, Chief of Staff, Joint Committee on Taxation, and others regarding H.R. 13 Anti-Deferral Legislation, reprinted at Volume 29, No. 23, Tax Analysts' Daily Tax Highlights and Documents (May 3, 1993) at 1433.

31 See Sessions Statement at L-3

The PFIC rules were designed to remove the advantage that investors formerly obtained by investing in an offshore passive investment vehicle as compared to a U.S. passive investment vehicle.[32] We believe that the CFCs targeted by the proposal are not operated to, and do not, attract investors seeking offshore passive investments. Therefore, we believe that the proposal cannot be justified by a suggestion that the affected CFCs are somehow improperly avoiding the PFIC rules.

The proposal has also been justified on the basis that current law creates a significant tax incentive to hold earnings in passive investments offshore.[33] We do not agree. We believe that these decisions are made largely for business reasons with tax considerations providing at most an incidental, not a significant, incentive one way or another. We believe that, all other things being equal, a CFC that is not a PFIC will prefer an active investment or reduction of debt to a passive investment. In general, the latter will yield a lower return. To the extent that tax considerations have any effect on this decision, they also militate against the passive investment because the income from a passive investment, in contrast to the income from an active investment, will be currently taxed to the CFC's U.S. shareholders under Subpart F.

We also believe that a CFC's decision whether to repatriate foreign active earnings or invest them in passive assets will be made most frequently on the basis of the relative cash needs of the CFC and its parent. Moreover, if the CFC operates in a jurisdiction, including most developed countries, that imposes an effective rate of tax at least as high as the

---

[32] See 1986 Blue Book at 1023.

[33] See Sessions statement at L-3.

U.S. rate, then repatriation of the CFC's active earnings should be without significant U.S. tax consequences because the foreign tax credit should absorb any U.S. tax otherwise applicable. The tax disincentive to repatriation in that case may be the foreign withholding tax that might apply, a factor to which the proposal is obviously not relevant.

Thus, current U.S. tax law may create a relatively significant incentive for a CFC to invest active earnings in passive assets only where the CFC operates in a low-tax jurisdiction, the cash needs of the CFC and its parent are a relatively insignificant consideration and there are no prospects for active investment by the CFC. Even assuming that, as a matter of tax policy, passive investment by a CFC in these circumstances should be discouraged, an assumption with which we do not necessarily agree, the proposal goes much further than is appropriate to accomplish this tax policy objective. Therefore, we recommend that, if enacted, the proposal should be narrowed as follows:

(a) <u>The proposal should allow an exemption where earnings are subject to high foreign taxes.</u>

The proposal should be modified so that it does not apply to earnings that are or have been subject to high foreign taxes. This would provide an objective, although somewhat crude, filter to trap those CFCs that, for tax reasons, retain earnings in offshore passive investments.

We note in this regard, however, that the Section 954(b)(4) method for determining whether income has been subject

to high foreign taxes suffers from significant shortcomings.[34] These include a potential failure to qualify a CFC's Subpart F income as being subject to high foreign taxes solely because the tax base in the foreign jurisdiction differs from the amount of Subpart F income required to be included in the income of the CFC's U.S. shareholders (the "tax base discrepancy problem")." Therefore, although we do not at this point recommend any particular method for identifying high-tax jurisdictions, we believe that if the proposal is modified along the lines described in this recommendation 3(c), the shortcomings in Section 954(b)(4) that have been identified by the above-referenced commentators should be avoided.[35]

(b) The proposal should narrow the definition of passive assets.

An alternative to recommendation 3(a) would be to have a much narrower definition of passive assets. For example, passive assets could be defined as stock in less than 5%-owned corporations (borrowing from the FIRPTA area), debt, and assets

---

[34] See, e.g., Letter dated March 12, 1993 from Mare E. Lackritz, President, Securities Industry Association, to Norman Richter, Esq., Department of the Treasury reprinted in 93 Tax Notes International at [63-15] (April 2, 1993); Letter dated February 26, 1993 from Kenneth Kies to Internal Revenue Service regarding the Proposed 1993 Business Plan, reprinted in Tax Analysts' Daily Tax Highlights and Documents (March 25, 1993) at 4373.

[35] Under one alternative for identifying high-tax jurisdictions, the legislation would either set forth a list of designated high-tax jurisdictions that would qualify CFCs operating therein as being subject to high foreign taxes, or contain a delegation of authority to the Secretary to publish such a list. Under a second alternative, earnings would be exempt from the proposal where the rate of foreign tax paid by the CFC would exceed a threshold percentage of the U.S. rate if the CFC's income were calculated according to foreign tax principles (at least to the extent that such principles are similar to U.S. tax principles). This would help rationalize the operation of the high tax exception in cases in which the tax base discrepancy problem exists.

giving rise to interest or dividend equivalent income. This definition would target corporations that are keeping liquid assets abroad to avoid U.S. taxes on repatriation. A "reasonable needs of the business" exemption might be added to cover the seasonal business problem discussed at Comment 6 below. A proposal of this type could even be coupled with a lower passive asset threshold than the 25% that is currently in the proposal. For example, a 10% threshold might be appropriate.

4. The proposal should not apply retroactively.

We believe that it is fundamentally unfair, and inconsistent with principles of taxation that have long guided legislation in this country, to force the inclusion in income of earnings that have already been determined not to be includible in income until some realization event occurs. Under the proposal, a CFC could be required to reexamine and alter the treatment of earnings accumulated as long ago as 1913. The accumulated earnings tax ("AET") to which the proposal is comparable, applies only to current earnings. Even the PFIC rules, which many regard as the most draconian of international tax rules, do not apply to earnings accumulated prior to the enactment of the rules.[36] We also note that the U.S. shareholders who will bear the tax burden may not have been stockholders at the time the accumulated earnings were generated, further compounding the inequity of a retroactive rule. Therefore, the proposal should apply only to earnings and profits accumulated after its effective date.

[36] Although prior years' earnings are relevant under the AET to determine if earnings have been accumulated unreasonably, the actual tax applies only to current earnings. Similarly, although the relative magnitude of a foreign corporation's passive assets may be relevant under the PFIC rules, it is only relevant for purposes of determining whether a foreign corporation qualifies as a PFIC. The PFIC rules generally do not require current taxation (or its equivalent, an interest charge) with respect to amounts in excess of current earnings and profits.

5. The proposal should provide an election to determine passive assets with reference to basis or fair market value.

The proposal provides that the level of a CFC's excess passive assets must be computed with reference to the assets' basis, not their fair market value. The proposal also provides that CFCs must apply the PFIC asset test with reference to their assets' basis not fair market value. As such, active business assets will be included in the equations, at depreciated basis, while passive assets will frequently be included at or close to fair market value.[37] Because short term investments are more likely to have high basis relative to value than long term investments, the proposal thus has the anomalous result of penalizing those CFCs that keep their passive assets in short term investments so as to be prepared to meet unexpected opportunities to invest in their active businesses.

We believe that this provision constitutes an attempt to maximize the revenue potential of the proposal at the expense of the better policy, which favors an election on the part of the taxpayer to use basis or fair market value. The objective of the proposal is to determine which CFCs are too heavily invested in passive assets. Obviously, this determination is more accurately made with reference to asset value rather than asset basis. Indeed, this is the approach that was taken by Section 1296 when it was first enacted.[38] In response to comments by certain PFIC shareholders that it was more administratively convenient for

[37] We do note, however, that appreciated stock of less than 25%-owned subsidiaries will figure in the equation to the taxpayer's advantage.

[38] See Pub. L. Mo. 99-514, § 1235(a).

them to test for PFIC status with reference to asset basis, the election to use basis was added to Section 1296.[39]

He are aware that the proposal has omitted the election (and, indeed removed it in the PFIC context for PFICs that are CFCs) because of enforcement and administrability concerns.[40] As long as the burden of proving value remains on the taxpayer, however, administrative convenience to the Secretary should not be a great concern. Moreover, even if an election might potentially make audits more time consuming, in a situation such as this, where the substantive rule itself is harsh, administrative convenience cannot override the need to guard against the totally inappropriate results that can obtain when depreciated basis is used for active business assets while high basis is used for passive assets. Therefore, we recommend a fair market value election.

Finally, we see no reason why PFICs that are CFCs should be treated more harshly than PFICs that are not CFCs. Therefore, we recommend that the proposal to eliminate the election for PFICs that are CFCs be reconsidered.

---

[39] See Pub. L. Mo. 100-647, § 1012(p)(27)

[40] See House ways and Means Committee Report at 254-55. He note that the legislative history states that asset basis is “highly appropriate” for measuring CFC earnings invested in passive assets. See House ways and Means Committee Report at 255. The problems glossed over by the legislative history, however, are, first, that asset basis is inappropriate for measuring CFC earnings invested in active business assets and, second, that the term “passive asset” is broadly defined.

6. The proposal should allow an election to defer the payment of tax subject to an interest charge.

We believe that in many cases, the rules will require an inclusion in income with respect to past earnings that are currently invested in assets that either are illiquid or can only be disposed of in derogation of the CFC's legitimate business objectives. For example, if the CFC has invested its active earnings in real property that produces rental income that does not qualify as active rent under the PFIC rules, its U.S. shareholders may be faced with a large income inclusion, the tax on which can only be paid through a disposition of the real property. As another example, U.S. shareholders of a CFC which conducts commodities operations that are not considered active under the PFIC rules would face a similar problem.

A further practical difficulty with the proposal is that a cyclical business may be inadvertently disadvantaged by the requirement that excess passive assets are to be determined by quarterly averaging. For example, a sales agency may hold predominantly cash or cash equivalents for the first nine months of the year, invest in inventory in October, and sell in November and December. Such a corporation's cash needs are business-related, yet it would be penalized by the proposal. It is evident that a blanket 25% safe harbor for passive assets may be excessive for some businesses and inadequate for others.

As illustrated by the examples set forth above, the proposal can have the effect of imposing a tax on a U.S. shareholder of a CFC that holds illiquid assets or assets that can only be disposed of in contravention of the CFC's business objectives. Therefore, at a minimum, U.S. shareholders should be given the option, as is provided to PFIC shareholders, of

electing to defer the payment of the tax resulting from the proposal as long as they pay an interest charge for the deferral and the deferral terminates to the extent of distributions from the CFC. In addition to Section 1294, Sections 453A and 668 provide precedents for this approach.

7. The proposal should include relief for corporations changing businesses.

If a CFC engaged in an active business disposes of its assets and holds the proceeds for a short period before reinvesting them in another active business, the proposal should not apply to the CFC's U.S. shareholders. Similarly, a CFC should not be subject to the proposal solely because, in its first taxable year, it is not able to invest its initial capital quickly enough in active assets. Although these are but two of a number of situations in which a CFC might hold excess passive assets for valid business reasons, they are situations for which relief has already been provided in the PFIC area.[41] Therefore, it is one for which relief should be provided under the proposal.

8. The proposal should not treat Section 956A inclusions as PFIC excess distribution.

H. R. 2264 Section 14231(d)(2) would amend Code Section 1297(b) so as to cause inclusions under new Code Section 956Aa to be treated as distributions for PFIC purposes. The effect of this change is to cause such inclusions potentially to be treated as PFIC “excess distributions”. If a Section 956A inclusion that was an excess distribution contained pre-1987 accumulated earnings and profits, the interest charge rules would apply to such pre-1987 accumulated earnings and profits.

[41] See Section 1297(b)(2) & (b)(3)

By treating the tax on excess distributions that are allocated to pre-1987 years as not subject to an interest charge, the PFIC rules currently attempt to approximate the treatment that would result if the tax on pre-1987 earnings and profits that are distributed were not subject to the interest charge. We view with dismay, and recommend against the policy change that now countenances an interest charge with respect to pre-1987 earnings and profits.

June 11, 1993

NEW YORK STATE BAR ASSOCIATION TAX SECTION

Report on Certain Compensation-Related Provisions of H.R. 2141

June 10, 1993

This report sets forth our concerns[*], on both policy and technical grounds, regarding the pending proposal (Section 14211 of H.R. 2141) to limit to $1 million the annual compensation deduction for each of the top five executives (the "Covered Employees") of publicly held corporations.[**]

Policy Analysis

As a matter of tax policy, we believe the proposal is misguided for a number of reasons:

- The provision is not based on sound tax theory but rather attempts to use the tax system, arbitrarily and inconsistently, to achieve objectives better left to the SEC and state corporate laws.

- Abuses in executive compensation have been addressed by the SEC, which has only recently promulgated major new shareholder communication and disclosure rules in the executive compensation area. In light of these ongoing initiatives, it is

[*] This report was prepared by a subcommittee of the Committee on Qualified Plans and the Committee on Nonqualified Employee Benefits, consisting of Stuart N. Alperin and Kenneth C Edgar, Jr., co-chairs of the Committee on Qualified Plans and Stephen T. Lindo and Loran T. Thompson, co-chairs of the Committee on Nonqualified Employee Benefits, who were the principal authors, and Stanley Baum, Carol I. Buckmann, Matthew L Eilenberg, Brian T. Foley, Claude E. Johnston and Max J. Schwartz. Helpful comments were received from Peter C. Canellos, Michael L. Schler and Richard L. Reinhold.

[**] We have also included a brief comment on the proposed $150,000 cap on compensation which can be taken into account for qualified plan purposes under Code Section 401(a)(17). See Section 14212 of HR 2141.

inappropriate - and at best premature - for Congress to regulate this area further through tax legislation.

- The proposal is projected to have no significant revenue-raising potential and, in view of its compliance cost and complexity, cannot be justified on cost-benefit terms.

- The proposal is arbitrary and inequitable and will penalize shareholders of public corporations.

- The legislation places U.S. public companies at a competitive disadvantage vis-a-vis their domestic and foreign rivals.

Some of these concerns are discussed in greater detail below.

1. Lack of Tax Rationale

The proposed $1 million cap bears no reasonable relationship to the proper measurement of taxable income. Compensation disallowed under the provision is indistinguishable, from the viewpoint of tax policy, from compensation not disallowed; e.g. because it is paid to persons who are not Covered Employees or paid by non-public companies. Some of these distinctions are particularly perverse from a tax policy standpoint - e.g. compensation paid by closely held companies is more likely to raise deductibility issues since it may entail disguised distributions to shareholders. These inconsistences demonstrate the inappropriateness of using the tax law to respond to a perceived non-tax problem.

2 SEC Initiatives

In response to a widely held perception that executive compensation deserved closer scrutiny, the Securities and Exchange Commission recently adopted significant revisions to the proxy disclosure rules with respect to executive compensation. Among other things, the SEC requires (a) extensive tabular disclosure of the compensation paid to the top five officers of a publicly held corporation, (b) graphic performance comparisons with other publicly traded companies and (c) a report by the compensation committee of the corporation's board of directors explaining in detail the compensation of the chief executive officer as well as the relationship between executive pay and corporate performance. In addition, the SEC has enhanced shareholders' ability to communicate with each other and submit compensation-related proposals to a shareholder vote.

With the drawing to a close of the first proxy season under the new SEC rules, it has been widely reported that the new rules have elicited favorable shareholder response. The SEC has been carefully scrutinizing proxy statement descriptions of executive compensation and plans to announce further guidance on this subject in the near future. Moreover, shareholders have availed themselves of the liberalized communication rules to increase their influence with respect to corporate governance matters.[***]

These SEC initiatives recognize that overall authority and responsibility relating to executive compensation has resided, and should continue to reside, in boards of directors and compensation committees of publicly held corporations, and

[***] See "New Proxy Rules Embolden Shareholders," New York Times Col 3, p. 37 (May 31,1993).

that the interplay between boards of directors and the shareholders to whom they are accountable is the most effective means for ensuring that executive compensation levels are not excessive. The SECs initiatives in this area, together with the increased level of shareholder activism, may go a long way toward curing the ills (both actual and perceived) which have arisen in recent years in the executive compensation area. The proposal presumes that these initiatives will be ineffective; we believe that they deserve to be given a chance to work.

3 Arbitrary and Inequitable Effects of Proposal

As noted above, the proposal creates arbitrary and inequitable distinctions among taxpayers. The proposed $1 million annual cap on deductible compensation would apply to all publicly held corporations, regardless of their size or the existence of circumstances justifying the compensation. Since the Code already disallows a deduction for unreasonable compensation, the only amounts affected by the proposal will be payments that are otherwise "reasonable." By statutorily deeming compensation above $1 million to be excessive (subject to certain exceptions), the proposal would run counter to the history of the Code, under which the reasonableness of compensation has been based on the surrounding facts and circumstances. The proposal would unfairly penalize both larger corporations which, due to their size, are more likely to provide higher compensation levels to Covered Employees, and corporations which find it necessary for competitive, financial or other legitimate business reasons to incur compensation expense in excess of the proposed cap.[****]

[****] Ironically, those corporations at which the proposal is primarily aimed corporations which are performing poorly but paying significant executive compensation, to the detriment of shareholders - are least affected by the proposal because they are more likely to be in a net

Past attempts to restrict compensation practices through tax legislation have been unsuccessful, and have tended to penalize shareholders. The “golden parachute” excise tax (and corresponding denial of a corporate deduction) devised in 1984, in response to legitimate concerns regarding large severance benefits payable to corporate executives in the event of takeovers of their companies, provides a revealing lesson in how attempts to modify corporate compensation practices through the tax system have proved ineffective. Initially that legislation induced corporations to limit parachute payments to the Section 280G “safe harbor” (i.e. less than three times the executive’s five year average compensation). Many other corporations, however, increased severance benefits to the safe harbor level established, and apparently sanctioned, by Congress. Soon, moreover, a substantial number of corporations revised their agreements so as not to arbitrarily limit payments to the safe harbor amount, and in fact went further by “grossing up” the executive for any payments which are subject to the 20% excise tax. The net result has been that the statute has failed in many instances to produce the intended change in corporate behavior, and the net cost of such arrangements to shareholders has been increased.

It is also significant that these parachute provisions are so complex that some nine years after their enactment no final regulations have been promulgated, and considerable confusion surrounds the proper interpretation of these rules. Enactment of a $1 million annual deduction cap promises to run into similar difficulties which will substantially outweigh any

---

operating loss position, in which case the lost deduction for “excessive” executive compensation may be of little consequence.

benefits (the nature and extent of which are at best elusive) of the new provision.

4. Competitive Effects

The singling out of domestic publicly held corporations for special treatment may have significant competitive effects. For example, the proposal would create an unlevel playing field to the advantage of foreign corporations, private U.S. corporations and partnerships without any policy justification. One obvious area in which U.S. publicly held corporations will be disadvantaged is the competition for executive talent, where foreign and private competitors will be free to offer compensation packages which are not dependent on subsequent shareholder approval.

Technical Issues

The proposed legislation presents a number of technical issues that may not easily be resolved. Among them are the following:

- The effective date of the proposal may cause 1993 bonuses payable and otherwise deductible in 1994 to be nondeductible without corporations having had an opportunity to seek shareholder approval.

- We question why amounts earned before an individual became a Covered Employee (as a result of a promotion for example), should count against the limit merely because such amounts were paid while the individual was a Covered Employee.

- If a corporation is publicly traded for only a portion of a year, how would the limit on deductibility apply?

- The shareholder approval requirement, as applied to cash and possibly stock incentives, could be read to require that separate votes be obtained for each award to any Covered Employee for each year. Such a requirement would be cumbersome at best.

- If individual shareholder approval is required, as described above, the company may not know the identity of the individuals for whom such approval is necessary (e.g.. an individual who is not a Covered Employee at the time shareholder approval is sought may become a Covered Employee at the time of payment and vice versa)

- The shareholder approval requirement appears particularly onerous in the case of new hires - neither the Company nor the prospective new hire can reasonably be expected to proceed if any negotiated arrangement is subject to future shareholder approval as a condition precedent to payment of the executive's compensation. This may be particularly true in turnaround situations at distressed companies.

- The need to have shareholders approve individual performance goals could result in the disclosure of proprietary information that would place employers at a competitive disadvantage. It would also run contrary to the recent efforts of the SEC to balance the need for greater disclosure with the need for some confidentiality regarding the specific terms of such awards.

- In the case of discount stock options under a shareholder-approved plan, we question why future stock appreciation above the market price at grant should not be eligible for the same performance-based exclusion that applies to stock options priced at market, if approved by shareholders.

- Similarly, in the case of a shareholder-approved restricted stock plan, we question why the appreciation in value of a restricted stock award over its value on the date of grant should not also be eligible for the performance-based exclusion.

For the foregoing reasons we urge that the proposal be removed from the tax law changes currently under consideration.

Finally, we have a brief comment with respect to the proposed lowering to $150,000 of the cap on compensation which can be taken into account under a qualified plan pursuant to Code Section 401(a)(17). While we recognize the need for deficit reduction and support that goal, we believe that in this instance the goal is being accomplished in a manner which is contrary to sound pension policy because, among other things, the maintenance and extension of qualified plans to non-highly compensated employees will be discouraged. Assuming, however, the $150,000 cap proposal is enacted, it will create a serious problem for those employees who earn over $150,000, but who may not qualify as "highly compensated" for purposes of the Employee Retirement Income Security Act of 1974, as amended ("ERISA").[*****] If the proposed change is enacted, an employer will be unable to provide either a tax qualified pension or an unfunded nonqualified pension to such employees with respect to their compensation above $150,000. This result occurs because (i) such compensation may not be taken into account in a funded, qualified plan under Code Section 401(a)(17) and (ii) provision of an unfunded pension for an employee who is not "highly compensated" is prohibited by ERISA Sections 201(a)(2), 301(a)(3), 302,401(a)(1) and 403. The only remaining method of providing pensions would be on a currently taxable basis (e.g., through a nonqualified, taxable trust or a taxable annuity). To rectify this unintended denial of tax-deferred pension benefits we suggest that the definition of "excess benefit plan" contained in ERISA Section 3(36) be amended to include a plan maintained by an employer to provide benefits

[*****] There is no "bright line" to establish who is highly compensated for purposes of ERISA. What little authority there is, however, suggests that merely because an individual earns $150,000 it is far from certain that he or she would be considered highly compensated under ERISA.

and contributions for employees which are otherwise precluded by the limitation imposed by Section 401(a)(17) of the Code. Such benefits could then at least be provided on an unfunded basis pursuant to ERISA Section 4(b)(5).

TAX SECTION
New York State Bar Association

New York State Bar Association Tax Section Committee on Tax Policy

Report on Eneroy Tax Provisions of H.R. 2141

This Report[1] comments on Section 14241 of H.R. 2141, the Revenue Reconciliation Bill of 1993 (the "Bill"), as submitted on May 18, 1993 by the Committee on Ways and Means of the House of Representatives to the House Committee on the Budget. Section 14241 imposes new Federal excise taxes on electricity and on fossil fuels (i.e., refined petroleum products, coal and natural gas) that are not used to generate electricity. Refined petroleum products are subject to tax at a higher rate, relative to their BTU content, than other energy sources.[2] The rate of tax on electricity produced by a particular facility is determined based on the mixture of energy sources used to generate electricity from that facility during the preceding month.[3]

---

[1] This report was drafted by Robert H. Scarborough and Reuven S. Avi-Yonah. Helpful comments were received from Peter C. Canellos, Anshel David, Richard M. Leder, Cynthia Mann, Elaine Velisaris, David E. Watts and Robert R. Wootton.

[2] See section 4081(b) (all section references are to the Bill, unless otherwise indicated).

[3] See section 4446(d).

This Report comments on collection mechanisms provided by the Bill for these taxes and on exemptions from these taxes. This Report also comments on certain problems that arise in determining the mixture of energy sources used to generate electricity from a particular facility, and on the taxation of natural gas based on its assumed BTU content. This Report does not comment on the basic policy issues presented by the proposed energy taxes: Should Congress raise additional revenue through a tax on consumption, such as an energy tax, rather than through the income tax? Should Congress, having decided to employ a consumption tax, do so by taxing only a particular category of products--energy--rather than through a broad-based consumption tax? Should a consumption tax on energy be based on BTU content, or should it be an ad valorem tax?[4]

1. Collection Mechanisms

In choosing the collection point for an excise tax, such as the energy tax, Congress must balance several competing considerations. As the Treasury Department observed in testimony in 1988[5] regarding the gasoline and diesel excise taxes, imposing the tax as far "upstream" in the distribution chain as possible will minimize opportunities for evasion.[6] Imposing the tax farther "downstream" has two advantages, however. First, it reduces the chance that products that are added to taxable fuel ("additives") will go untaxed. Second, it minimizes the instances in which refunds of tax are necessary with respect to fuel that will eventually be used for exempt purposes.

Evasion will be minimized by imposing the tax at the highest possible level in the distribution chain, for several reasons. First, it results in a shorter audit trail by reducing the number of times that a particular amount of taxable product changes hands between the time the fuel is produced or imported

[4] We note, however, that a BTU tax has two advantages over an ad valorem tax: If the goal of an energy tax is to encourage conservation of energy based on BTU consumption, basing the tax on BTUs is more directly linked to that goal than an ad valorem tax; and a BTU-based tax is more neutral among possible collection points than an ad valorem tax, because the price of fuel may change significantly along the distribution channel.

[5] Statement of Dennis E. Ross, Deputy Assistant Secretary (Tax Policy), Department of the Treasury, Before the Subcommittee on Energy and Agricultural Taxation, Committee on Finance, United States Senate (March 16, 1988).

[6] Congress moved the collection point of the gasoline excise tax upstream in 1986 in response to widespread evasion by the numerous persons who were eligible to purchase gasoline tax-free and who were reselling it as tax paid and pocketing the difference.

and the time that the tax is collected. Second, it minimizes the number of transactions on which tax is imposed, while maximizing the average amount of taxable product per transaction. Third, it minimizes the number of persons eligible to buy product that has not yet been taxed and then remit the tax to the Treasury Department, and thus minimizes the number of persons that the Internal Revenue Service must audit. Fourth, persons at a higher level in the distribution chain are, on average, financially more sound and maintain better records than persons at a lower level in the distribution chain.[7]

a. Collection Point for Refined Petroleum Products. Coal and Natural Gas

In the case of refined petroleum products, the Bill strikes the same balance among these considerations that Congress did in 1986 when it moved the collection point for the gasoline excise tax "upstream" from the last sale before retail to removal from the terminal.[8] As in the case of the current law gasoline excise tax, the new excise tax on refined petroleum products would be imposed upon removal from the terminal.[9] In both cases, the principal reason for choosing this collection point, rather than a point that is "lower" in the distribution chain, is to reduce evasion. We endorse this decision.

We express no view as to whether Congress should choose a collection point that is "higher" in the distribution chain—removal from the refinery or from the first storage point in United States customs custody. Such an approach would be similar to that used in New York for the collection of the State gasoline

---

[7] See Id.

[8] See section 4081 (current law). The bill would move the collection point for the current law diesel excise tax to the terminal rack, thereby conforming it to the collection points for the gasoline excise tax and the new energy tax. See section. 4081 (as amended by the Bill); House ways and Means Committee Report 103-11 (May 19, 1993), reprinted in Daily Tax Report (May 20, 1993) (the "HSM Report"), 310-12.

[9] Like the gasoline excise tax, the energy tax would be imposed on the earliest of (i) removal from the refinery, (ii) removal from the terminal, (iii) entry into the United States for consumption, use, or warehousing and (iv) sale to any person who is not registered. The energy tax would not be imposed, however, on removal or entry of petroleum products transferred in bulk to a refinery or terminal if both parties to the removal or transfer are registered. This exception mirrors the exception under the current gasoline excise tax for bulk transfers to registered terminals. Accordingly, the energy tax, like the gasoline excise tax, generally will be collected upon removal from the terminal.

excise tax.[10] Although collection as far "upstream" as possible would minimize evasion, it could increase problems with exempt uses.

The Bill strikes a different balance in the case of natural gas and coal. Under the Bill, natural gas generally would be taxed upon removal from a registered pipeline to an end user (i.e., at the retail level).[11] Under the Bill, coal, other than coal used by a registered person for the generation of electricity, would be taxed upon receipt at any facility for use as a fuel.[12]

b. Electricity

Under the Bill, all electricity used in the United States would be taxed upon sale to the end user.[13] Although the purchaser of the electricity would pay the tax, the Bill provides that the person selling electricity to the end user, generally a utility, would collect and remit the tax. The Bill provides that, except in the case of sales to large users, the seller "shall also be liable" for tax "which is not collected from the person to whom the electricity is sold".[14] The legislative history characterizes this provision as "secondary liability" and states that if the end user falls to pay the tax the Treasury Department may seek collection from either the seller or the end user.[15]

We agree with the general approach of imposing the tax on electric utility customers, rather than on the fuel used to produce electricity. The considerations that support imposition of the tax as far upstream as possible in the case of refined petroleum products are not present in the case of electricity. Evasion by electric utilities—which operate in a regulated environment and are subject to intense public scrutiny—seems highly unlikely. We also agree that the customer, rather than the utility should be liable for the tax. This approach helps ensure that the tax will achieve its goal of encouraging conservation

---

[10] See NY Tax Law (McKinney's) §12-A.

[11] See section 4444; W&M Report at 299.

[12] See section 4445

[13] See section 4446(a). Use of electricity not subject to tax on sale would be taxed on use.

[14] See section 4446(c).

[15] See W&M Report 301 & n.105.

but does not require normalization-like sanctions to ensure that regulators permit pass through of the tax to ultimate consumers.

We question the "secondary liability" provision contained in the bill, however. We do not believe that utilities should be liable for tax that is not paid by consumers.[16] We assume that state regulators would permit utilities to include tax for which they are secondarily liable in their cost of service for ratemaking purposes.[17] In this case, the tax that some customers fail to pay will, in effect, be paid by other consumers of electricity. These consumers will implicitly be subject to tax at a higher rate than persons who consume energy from the same sources that is not used to produce electricity. Such a result would frustrate the goal of taxing all uses of energy from the same source at the same rate. We recommend that the secondary liability provision in the bill be deleted and that any resulting revenue loss be made up by increasing the tax rates.

If the secondary liability provision is retained, we believe that its operation should be clarified. Although the legislative history refers to secondary liability, the statutory language does not and appears to impose joint and several liability for the tax and the utility and its customer. We also note that the legislation does not provide specific rules for the time and manner of collection and remittance of the tax.

We believe that the Bill should be amended to make clear that a utility is not responsible for remitting the tax until some specified time after the sooner of payment by the customer of the amount of the tax to the utility and the due date of the bill. Alternatively, the Bill might provide that a utility is liable only after the customer fails to pay the tax and the utility has taken reasonable steps to collect the tax. At the very least, the utility should not be required to remit the tax until it has had a reasonable chance to collect it from the customer.

We are concerned that, absent such clarification, the Treasury Department might require utilities to remit the tax by

---

[16] We note that the telecommunications excise tax is imposed directly on consumers, and that telephone companies are not secondarily liable for tax that their customers fail to pay. See section 4251.

[17] If regulators did not permit a utility to recover this tax directly through their cost of service, we believe that market forces would increase the utility's cost of capital. Since utilities are permitted to recover their cost of capital through rates, the effect on consumers that pay their bills would be approximately the same.

the end of a specified time after electricity is furnished. Although this approach would maximize revenue in the first fiscal year in which the tax is in place, it would be inconsistent with the decision to impose the tax on utility customers.

The rules applicable to telephone companies for collecting the federal communications excise tax provide a possible model for how the tax on electricity might be collected. These rules[18] coordinate a utility's responsibility for depositing the tax with its collection of the tax from customers.

2. Problems in Computing Rate of Tax on Electricity Produced by a Facility

a. Bulk power sales

We are concerned that computation of the applicable tax rate on electricity purchased from a pool or in bulk from another utility may, as a practical matter, be complex if not impossible. Problems are particularly likely to arise in cases in which electricity is purchased and sold numerous times before sale to the ultimate customer.

b. Sales to small resellers

The Bill requires utilities to provide information to purchasers in every case that electricity is sold to other than the ultimate user,[19] so that the purchaser can charge tax at the appropriate rate. We believe that Congress should adopt a different approach in the case of electricity sold to a person other than a utility (e.g., an apartment building) for resale, provided that such other person's purchases and resales do not reach a specified level. The tax would be collected upon the sale to the small reseller.[20]

c. Periodic recomputation of tax rate

The Bill[21] requires that utilities in effect recompute the rate applicable to their output on a monthly basis. We

---

[18] These rules are found in sections 4251 and 6302(e) and Reg. SS 49.4251-2 and 40.6302(c)-3.

[19] See section 4446(d)(4)

[20] Cf. section 4445(c)(2) (imposing tax on ultimate vendor rather than user in case of certain small coal facilities).

[21] See section 4446(d)

suggest that utilities be permitted to compute this rate quarterly or semiannually in order to simplify administration.

3. Taxation of Natural Gas Based on Assumed BTU Content

Under the Bill, natural gas is generally taxed on the basis of mcfs, with an assumed BTU content per mcf of 1.031.[22] This approach assumes that natural gas is typically purchased on the basis of mcfs, rather than BTUs, and that most natural gas has a relatively constant level of BTUs. In our experience, neither assumption is true. Most bulk consumers today buy gas on the basis of its BTU content, and some gas can have a BTU content of as little as 450 per cubic foot.

The Bill addresses these concerns by providing that the Secretary can shift natural gas taxation to an actual BTU basis by regulation.[23] We are concerned that the regulations will not be promulgated before the effective date of the tax (July 1, 1994), and that taxing natural gas on the basis of its assumed BTU content will result in over-taxation compared to the other fuels that are taxed on the basis of their actual BTU content. Therefore, we recommend that the Treasury should be encouraged to promulgate regulations for taxing natural gas based on actual BTU content prior to the effective date of the tax.

4. Exemptions and their Administration

The Bill provides for several partial or full exemptions from the energy tax. Some of these exemptions are designed to prevent double taxation (e.g., the exemption for energy used to produce taxable energy); others are designed to avoid taxing energy sources not used for energy (e.g., the exemption for electricity incorporated in aluminum products) or to protect particular end uses (e.g., the exemptions for heating fuel and for fuel used on farms).

In general, we believe that the structure of the tax should be as simple as possible, and therefore the number of exemptions should be limited. To the extent that exemptions are allowed, we believe that in the interest of simplicity and administrability, the exemptions should be narrowly drawn so as

---

[22] Section 4444(b)(1), (d)(1)(A). "Mcf" is defined as 1,000 cubic feet of natural gas at a pressure of 14.73 pounds per square inch and a temperature of 60 degrees Fahrenheit. Section 4444(d)(4).

[23] Section 4444(b)(2).

not to create more complexity than necessary to achieve their purpose.

In designing the ways in which the exemptions are administered, the Bill seeks to balance two competing considerations: On one hand, simplicity and fairness are furthered by limiting the number of instances in which tax is collected on energy used in exempt uses, and is therefore required to be refunded later (in most cases without interest).[24] On the other hand, in some cases the ultimate collection of the tax on nonexempt uses would be imperilled if it were not collected on energy used in exempt uses as well, e.g., if it would be difficult to collect the tax from the ultimate non-exempt user.

Overall, the Bill strikes an appropriate balance between these competing considerations. The general mechanism used to achieve this balance is to collect the tax in all cases, unless the party liable for the tax has registered with the Treasury department. The Secretary is granted broad authority to require registration from all persons owning, transporting, or otherwise controlling any taxable energy source before payment of tax as a condition of receiving the energy source without payment.[25] The Treasury may require proof of the existence of business operations, financial responsibility, and payment of other taxes as conditions for registration.[26]

The registration exemption applies only to registered persons who themselves use the energy product in the exempt use.[27] For example, if a registered person buys a petroleum product at the terminal rack for sale to another person, who in turn exports the petroleum product, the sale to the registered person will not be exempt even though exported energy is exempt. Instead, the tax will have to be passed on to the exporter, who will have to obtain a refund from the Treasury.[28]

Although the registered person may not know in this case that the petroleum product was actually exported, it is not clear why a tax must be levied in these circumstances if the registered

---

[24] Interest is provided only for the period beginning 20 days after a refund claim for more than $1/000 is filed. Section 4453(a)(3).

[25] Section 4453(d); W&M Report, at 303-304.

[26] W&M Report, at 304

[27] W&M Report, at 303-304.

[28] Section 4442(a)(5); W&M Report, at 304.

person has actual knowledge of the ultimate exempt use.[29] Instead, the tax could be Imposed unless the registered person certifies to its knowledge of the eventual exempt use, and the registered person could be liable for the tax if the eventual use turns out not to be exempt.

In two Instances, a different method of establishing an exemption without payment is allowed: fuel oil used for heating and diesel fuel used on farms for farming purposes can be transferred without payment of tax if they are indelibly dyed.[30] This mechanism avoids the payment and refund procedure for the ultimate vendors of home heating oil and farm diesel fuel. However, it may prove difficult to administer the distinction in the case of industrial users who use the same type of fuel for both heating and other applications, or farmers who use diesel for both farming and non-farming uses.[31] It may therefore be advisable to limit the tax-free purchase of dyed fuels to home heating oil sold to residential premises, where the likelihood of non-exempt uses is minimal.[32]

The following comments address some of the specific exemptions provided in the bill:

a. Feedstock use

An exemption is provided for energy sources used as raw materials in the manufacture of nonfuel goods, e.g., plastic products that incorporate hydrocarbon molecules from petroleum products or aluminum produced through electrolytic processes.[33] The Bill and the Committee Report attempt to define the exempt use so as to apply it to only those molecules or electrons actually incorporated into the finished product. Therefore, the person claiming the exemption will have the burden of certifying the “exempt percentage” of the energy used that is actually

---

[29] We recognize that the current gasoline excise tax exemption only applies to purchasers who use the gasoline in an exempt use. Current section 4093(c)(1).

[30] 30 Section 4441(b)(2)(B), (C); W&M Report, at 298, 306-307.

[31] W&M Report, 306-307 (noting that industrial users may purchase dyed fuel “only to the extent that the fuel will be used for heating purposes.”)

[32] A penalty is provided in new section 6714 for selling dyed fuel for a taxable use or using dyed fuel in a taxable use, but the enforcement of this penalty will require significant and expensive audit efforts, Involving actual Inspection of Industrial and farm facilities to determine the use of dyed fuels.

[33] Sections 4442(a)(3), 4444(e)(3), 4445(d)(2), 4446(e)(1).

incorporated into the finished product, and these percentages may be reviewed by the IRS as a condition for registration. The Committee Report specifies a 50% exempt percentage for aluminum; in other cases, the Treasury regulations are supposed to define the scope of the exemption.[34]

Such micromanagement at the molecular or even electron level seems grossly exaggerated, especially given that technological innovation is likely to result in rapidly changing exempt percentages and the Treasury will have a hard time keeping up. We therefore recommend that all energy sources partially used as feedstock, whether or not incorporated in the finished product, be taxable if more than a fixed de minimis percentage is not incorporated in the finished product.

b. Fossil fuels used in the generation of electricity

The bill exempts from tax fossil fuels used in the generation of electricity.[35] This exemption seems appropriate because the electricity itself will generally be subject to tax. However, if exempt fuels are used to produce steam in addition to electricity, a use tax is imposed on the portion of the fuel inputs used to generate the steam (based on the proportionate Btu contents of the electricity and the steam), unless the steam itself is used in an exempt purpose.

Again, this provision is much too complicated. "Rough justice" is best in these circumstances, and we recommend that all fossil fuels used in the generation of electricity be taxed if steam is a by-product of the production process, unless the percentage used to generate steam is de minimis. The taxpayer may be given the option of proving that a certain percentage of the fuel is actually used to generate electricity, in which case the actual percentage method of the Bill can be used.

c. Fuels used in the production of taxable energy products.

In general, fuels used to generate taxable energy products should be exempt from the tax because their products will generally be taxable. However, the bill generally only exempts from tax fuels used on the premises to produce the same fuel, e.g., oil used at an oil refinery, or gas used at a gas processing plant. Some "cross-use" is also permitted, such as gas

[34] W&M Report, 305-306. Similar complicated issues arise under state sales tax laws that exempt materials physically incorporated into other products.

[35] Section 4442(a)(2)(B); W&M Report, at 307.

used on the premises to produce oil, and coal or oil used to produce gas.[36] However, electricity used to produce other taxable energy products is taxable.

While in general we believe that all uses of energy sources to produce taxable energy products should be exempt, we support the approach taken by the bill as a viable compromise between that policy goal and administrability concerns. However, we would recommend that electricity used in the production of taxable energy products be exempt, since the person liable for the tax is the ultimate user and it would therefore not be difficult to administer such an exemption at the end user level.

D. International commercial transportation

Ship or jet fuel used in international commercial transportation is exempt.[37] The rationale of this exemption, like the export exemption, is that the tax should be imposed only on energy used in the United States. However, the exemption does not apply to fuel used in the domestic segment of an international flight.[38] This provision again seems overly complex, and for administrative simplicity, we recommend that all fuel used in flights whose ultimate destination is outside the United States be taxable if more than a de minimis amount is used in the United States, and be tax-free is less than the de minimis amount is used in the United States.

---

[36] W&M Report, 307-308; sections 4442(a)(2)(B),(D), 4444(e)(2)(A), (C), 4445(d)(1)(A), (C), (D).

[37] Section 4442(b)(2).

[38] W&M Report, at 308.