

REPORT #862

TAX SECTION

New York State Bar Association

Letter on Administrations's 1995 Tax Proposal

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January 29, 1996

Glen A. Kohl, Esq.
Tax Legislative Counsel
Department of the Treasury
1500 Pennsylvania Ave., N.W.
Washington, D.C. 20220Re: Administration's December 1995 Tax
Proposal to Expend Subpart F
Provisions Regarding Income from
Notional Principal Contracts and
Stock Lending Transactions

Dear Glen:

As a follow-up to my letter dated December 22, 1995, this letter provides the Tax Section's comments on the Administration's proposal, released by the Treasury on December 7, 1995, and described in the Joint Committee Staff's December 15, 1995 Description (JCX-5B-95), to expand the provisions of Subpart F regarding income of controlled foreign corporations ("CFCs") from notional principal contracts ("NPCs") and stock lending transactions (the "proposal"). These comments are subject to the same caveats set forth in my December 22 letter.

The Proposal would create a new category of Subpart F income for income from NPCs. This category would include income from certain NPCs that currently are included in

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Subpart F income under the categories for foreign currency, commodities and income equivalent to interest. In addition, this new category would include income from equity swaps and other types of NPCs that currently are not Subpart F income. However, any income, gain, deduction or loss from an NPC entered into to hedge an item of income in a category of foreign personal holding company income (other than dividends, interest, royalties, rents, annuities or dividend equivalent payments) would be allocated to that category. An ordinary course of business exception would be provided for regular dealers in NPCs, forward contracts, options and similar financial instruments (including instruments referenced to commodities). Finally, dividend equivalent payments made pursuant to a securities lending transaction that qualifies under section 1058 would be included in the existing category of foreign personal holding company income that includes interest, dividends, etc.

We believe that an exception should be provided for any income, gain, deduction or loss from an NPC that is part of a bona fide hedging transaction. We believe that the exception should apply to bona fide hedging transactions described in Treasury regulations section 1.954-2(a)(4)(ii). Thus, for example, an interest rate swap that is a qualified hedge of a liability should continue to be excluded from the Subpart F rules, as under current law (see Treasury regulations section 1.954-2(h)(1)(ii)). Also, a swap entered into to hedge inventory or similar property (as defined in Treasury regulations section 1.954-2(a)(4)(iii)) should be excluded from the Subpart F rules.

Typically, an NPC that is not part of a bona fide hedging transaction described above and is not entered into by a regular dealer in NPCs in the ordinary course of its business will be entered into by a CFC to hedge an investment that will give rise to dividends, interest, income equivalent to interest and/or gains that are foreign personal holding company income. Because losses and deductions falling into one category of foreign personal holding company income may not offset income in a different category (see Treasury regulations section 1.954-1(c)(1)(ii)), we believe that the Proposal is unduly harsh and inconsistent in not permitting the income, gain, deduction or loss from an NPC entered into to hedge dividends, interest, etc. to be allocated to that category, while permitting such an allocation where the NPC is entered into to hedge an item of foreign personal holding company income in a different category (apparently including gains and income equivalent to interest).

Beyond our specific comments, we think it unfortunate that the Proposal amends section 954 only to deal with relatively narrow deficiencies, and to raise revenue, without attempting to reduce the substantial complexities and anomalous results that obtain under the existing Subpart F provisions. We believe that some of the existing provisions can produce results that are not consistent with the purposes of the Subpart F rules. Some of these problems are highlighted by the Proposal and are illustrated below. We urge that the Treasury and Congress, as part of their consideration of the Proposal, consider additional provisions which would amend section 954 so that, while it continues to protect the revenue, it no longer inadvertently penalizes legitimate active foreign businesses.

As an example of our concerns, we note that under the Proposal section 954 would be amended to provide an ordinary-course-of-business exception for regular dealers in NPCs, forward contracts, options and similar financial instruments (including instruments referenced to commodities). We regard this proposed dealer exception to be sensible and appropriate. It is anomalous, however, that this rule would be enacted for NPC's, etc., while section 954 fails to provide a similar ordinary-course-of-business exception for regular dealers in securities with respect to dividend income, interest, income similar to interest and, under the Proposal, income from stock lending transactions which, in each case, arises from dealer property (as defined in Treasury regulations section 1.954-2(a)(4)(v)) or inventory or similar property (as defined in Treasury regulations section 1.954-2(a)(4)(iii)). We note that such an exception for dividends, etc., existed prior to the Tax Reform Act of 1986 but was eliminated as a result of the repeal of a broader exception for banking, financing or similar businesses. We also note that section 954 continues to provide an exception for gains from the sale of securities constituting dealer property or inventory or similar property, and that in the Revenue Reconciliation Act of 1993, Congress introduced an exception from the PFIC rules for CFCs that are securities dealers (section 1296(b)(3)); proposed regulations have now been issued under this latter provision which would treat dividends, interest and other similar income on dealer securities as active income for purposes of the PFIC provisions and section 956A. We suggest that, in the context of the current proposals to amend section 954, consideration be given to whether the ongoing distinction in the treatment of dividends, etc. is appropriate.

To give a second example of our concerns with the current application of section 954(a) (and by cross reference, section 1296(b)), the hedging exception for commodities, as well as the ordinary course of business exception, are very narrow in that they are available only to a CFC substantially all of whose business is as an active producer, processor, merchant or handler of commodities. However, as illustrated by the example of an airline hedging its fuel costs, legitimate commodities hedging activities are often entered into by other CFCs in the ordinary course of their business. Moreover, an active commodities merchant would lose the protection of the ordinary course of business exception for its sales of commodities held in inventory if, in addition, it is an active dealer in property that does not qualify as a commodity. We believe that the Subpart F rules should be amended to correct these problems, while still ensuring that commodities transactions that are primarily financial transactions or are otherwise capital transactions, not entered into in the active conduct of a commodities business or as a bona fide hedging transaction incident to the active conduct of a commodities business, give rise to Subpart F income.

Thank you for this opportunity to comment on the proposals. Please feel free to contact me (at 212-903-8761) Dick Loengard (at 212-859-8260) or Yaron Z. Reich (at 212-225-2540) should you wish to discuss these comments in greater detail.

Very truly yours,

Carolyn Joy Lee
Chair

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