

TAX SECTION

New York State Bar Association

REPORT ON PROPOSED REGULATIONS RELATING TO
THE ALLOCATION OF LOSS ON THE DISPOSITION OF
STOCK AND OTHER PERSONAL PROPERTY

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November 13, 1996

Hon. Donald C. Lubick
 Acting Assistant Secretary (Tax Policy)
 Department of the Treasury
 1500 Pennsylvania Avenue, N.W.
 Washington, D.C. 20220

Hon. Margaret M. Richardson
 Commissioner
 Internal Revenue Service
 1111 Constitution Avenue, N.W.
 Washington, D.C. 20224

Re: Proposed Regulations Relating to the
 Allocation of Loss on the Disposition
 of Stock and Other Personal Property

Dear Secretary Lubick and Commissioner Richardson:

I am pleased to enclose a report of the Tax Section of the New York State Bar Association regarding proposed regulations sections 1.865-1 and 1.865-2, relating principally to the treatment of losses from the sale or other disposition of stock. The report was prepared by Yaron Z. Reich, Co-Chair of our Committee on U.S. Activities of Foreign Taxpayers.

We generally agree with the approach taken in proposed regulation section 1.865-2, dealing with loss from the disposition of related party stock, although we have several comments and recommendations. However, we do not agree with the approach taken in proposed regulation section-1.865-1, dealing with the disposition of portfolio stock and other personal property not governed by section 1.865-2. We recommend instead that that provision be replaced with a rule similar to that contained

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in proposed regulation section 1.865-2(a), subject to specified exceptions, including an anti-abuse rule for cases where the portfolio stock is held for a brief period of time. Thus, we recommend that loss on the disposition of portfolio stock and other personal property generally be allocated and apportioned in conformity with the manner in which gain from the sale of such stock would be allocated and apportioned.

We also recommend deletion of the consistency rule of proposed regulation section 1.865-2(b)(2); the failure to delete this provision would, in our view, unfairly penalize taxpayers that utilize the election provided by section 865(f). If the consistency rule is retained, we recommend that it apply to loss on disposition of foreign affiliate stock only to the extent of gain that was sourced under section 865(f) during the preceding five years.

Finally, we recommend certain clarifications and modifications to the election to apply proposed regulation section 1.865-2 retroactively to all open years.

Please let me know if we can be of further assistance in finalizing the proposed regulations.

Respectfully submitted,

Richard L. Reinhold

cc: Joseph H. Guttentag
International Tax Counsel
Department of the Treasury

Philip R. West
Deputy International Tax Counsel
Department of the Treasury

Michael Danilack
Associate Chief Counsel (International)
Internal Revenue Service

Christine Halphen
Assistant Chief Counsel (International)
Internal Revenue Service

Bruce Cohen
Attorney Advisor
Office of International Tax Counsel
Department of the Treasury

Barbara A. Felker
Senior Technical Reviewer, Branch 3
Office of the Associate Chief Counsel
(International)
Internal Revenue Service

Seth B. Goldstein
Attorney Advisor, Branch 3
Office of the Associate Chief Counsel
(International)
Internal Revenue Service

New York State Bar Association
Tax Section

REPORT ON PROPOSED REGULATIONS RELATING TO
THE ALLOCATION OF LOSS ON THE DISPOSITION OF
STOCK AND OTHER PERSONAL PROPERTY*

I. INTRODUCTION.

This report comments on proposed regulations sections 1.865-1 and 1.865-2, and proposed changes to regulations sections 1.861-8 and 1.904-4,¹ relating principally to the treatment of losses from the sale or other disposition of stock.²

The proposed regulations under section 865, which deal with the source of losses from the sale or other disposition of stock, exercise authority granted under section 865(j) to prescribe regulations "relating to the treatment of losses from sales of personal property." In the case of U.S. taxpayers, the source of loss is relevant principally for purposes of applying the foreign tax credit rules. The proposed changes to regulations section 1.904-4 provide guidance regarding the treatment of stock losses for purposes of the separate foreign tax credit "baskets" under section 904(d).

* This report was prepared by Yaron Z. Reich, co-chair of the Committee on U.S. Activities of Foreign Taxpayers. Helpful comments were provided by Thomas Bryan, John A. Corry, Michael G. Devlin, Alan Dixler, David P. Hariton, Raymond Jasen, Charles I. Kingson, Richard O. Loengard, Jr., Richard L. Reinhold, Michael L. Schler and Louise Weingrod.

¹ All section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the Treasury regulations promulgated or proposed thereunder.

² 61 Fed. Reg. 35,696 (July 8, 1996).

II. DESCRIPTION OF THE REGULATIONS.

Proposed regulation section 1.865-1 provides that loss on the sale or other disposition of portfolio stock, stock of a regulated investment company or of an S corporation, or other personal property not governed by section 1.865-2 is governed by section 1.861-8 or other administrative pronouncements. Portfolio stock is defined as stock in a corporation in which the taxpayer owns, directly or by attribution, less than 10 percent of the voting power and value of the stock. Thus, as discussed in Part IV.A below, a portfolio stock loss involving stock of a foreign corporation generally will be treated as foreign source loss.

Section 1.865-2 provides as a general rule that loss on the sale or other disposition of stock that is not described in section 1.865-1 (essentially, "related party stock") is to be allocated and apportioned in the same manner as gain on such stock. Thus, stock loss on related party stock generally is allocated to the residence of the seller.³

This general rule is subject to three exceptions. First, under a dividend recapture rule, a stock loss that is realized on the disposition within 24 months after a dividend (or similar) inclusion is allocated to the same class of income as the dividend inclusion (in an amount up to such inclusion), subject to a de minimis exception if the sum of all dividend recapture amounts is less than 10 percent of the realized loss.

³ Special rules are provided for (i) loss of a U.S. person that is attributable to an office or other fixed place of business in a foreign country and (ii) loss of a non-U.S. person on the sale of stock that is a United States real property interest.

Second, under a consistency rule, loss recognized on the disposition of an 80%- owned foreign affiliate reduces foreign source passive income if, within the past five years, the seller or any member of its consolidated group recognized gain on the disposition of a foreign affiliate that was sourced under section 865(f).⁴

Third, under anti-abuse rules, if one of the principal purposes of certain specified transactions is to change the allocation of loss on stock or other personal property, the loss is allocated as if the transaction had not occurred.

Regulation section 1.865-2 is proposed to be effective for taxable years beginning after the date that is 60 days after the date the regulations are published as final regulations, but taxpayers would be permitted to elect to apply the regulations retroactively to all open taxable years beginning after December 31, 1986, subject to certain conditions.

The proposed changes to section 1.904-4 contain rules addressing the treatment of loss allocated to the section 904(d) separate category for passive income.

III. SUMMARY OF COMMENTS.

We generally agree with the approach taken in proposed

⁴ In general, section 865(f) provides that if a U.S. resident sells stock in a foreign affiliate, the sale occurs in a foreign country in which the affiliate actively conducts business and more than 50 percent of the gross income of the affiliate during a specified period is derived from such active business in that country, the gain is treated as foreign source gain.

The five-year look-back period under the consistency rule excludes gains recognized prior to September 7, 1996.

regulation sections 1.865-2 and 1.904-4, but we have the following comments and recommendations:

1. Proposed regulation section 1.865-1, dealing with loss from the disposition of portfolio stock and other personal property not governed by section 1.865-2, should be replaced with a rule similar to that contained in proposed regulation section 1.865-2(a), subject to specified exceptions, including an anti-abuse rule where the portfolio stock is held for a brief period of time.

2. The consistency rule of proposed regulation section 1.865-2(b)(2) should be deleted. If this recommendation is not adopted, the consistency rule should be limited so as to apply to loss on the disposition of foreign affiliate stock only to the extent of the amount of gain that was sourced under section 865(f) during the previous five years.

3. The election to apply regulation section 1.865-2 retroactively to all open years that begin after December 31, 1986 should be clarified and modified. Amended returns should be required only for those taxable years in which there was a sale of related party stock at a loss, and it should be sufficient to file a statement (rather than an amended return) for any such years in which the election does not result in a change in tax liability or that are under audit.

IV. DISCUSSION.

A. Portfolio Stock and Other Personal Property (Prop. Reg. Section 1.865-1).

The proposed regulations create a severe discontinuity between the treatment of losses from dispositions of portfolio stock and other personal property not governed by section 1.865-2, on the one hand, and the treatment of both (a) gains from dispositions of portfolio stock and other personal property and (b) losses from related party stock dispositions, on the other hand. While proposed regulation section 1.865-2 generally conforms the treatment of losses from related party stock dispositions to the treatment of gains under section 865, proposed regulation section 1.865-1 provides that losses from portfolio stock dispositions (as well as losses from the disposition of other property that are not governed by section 1.865-2) are governed by regulation section 1.861-8 or other administrative pronouncements. The preamble indicates that the "treatment of portfolio stock will be reviewed in the context of a broader project dealing with similar portfolio investments, including debt instruments and derivative financial products."

Under regulation section 1.861-8(e)(7), loss on the sale or other disposition of a capital asset is considered to be a deduction which is definitely related and allocable to the class of gross income to which the asset ordinarily gives rise in the hands of the taxpayer. In the case of stock held for investment, therefore, the loss would generally be allocable to dividend income. The deduction would then be apportioned to U.S. or foreign source pursuant to regulation sections 1.861-8(e)(7)(ii) and 1.861-8T(c). Accordingly, while some uncertainties exist in the application of these rules, in general, loss from the disposition of portfolio stock of a foreign corporation would be treated as foreign source loss.⁵

⁵ See *Black & Decker Corp. v. Commissioner*, 62 TCM 1204 (1991), *ajf d*, 986 F.2d 60 (4th Cir. 1993) (applying regulation section 1.861-8(e)(7) in the context of a worthless stock deduction in respect of the stock of a foreign subsidiary).

In contrast to proposed regulation section 1.865-1, which treats loss from the disposition of portfolio stock of a foreign corporation as foreign source loss, section 865 generally treats gain realized by a U.S. person from the disposition of any stock (regardless of whether it is stock of a domestic or a foreign corporation or whether it is portfolio stock or related party stock) as U.S. sourced, and proposed regulation section 1.865-2 generally treats loss from the disposition of related party stock consistently with the treatment of gain from such stock.

In 1986, through the enactment of section 865, Congress revised the rules for determining the source of gains from dispositions of personal property, and replaced the sourcing rule that had been based on the location where the sale occurred (the "title passage" rule) with a general sourcing rule based on the residence of the seller. A principal reason for this revision was to have the source rules for sales of personal property more closely "reflect the location of the economic activity generating the income, taking into account the jurisdiction in which those activities are performed."⁶ In keeping with this objective, the Senate Finance Committee Report states that, "in cases where manipulation of the title passage rule is relatively easy, (for example, sales of portfolio stock investments) the committee believes that the residence of the seller should govern the source of the income since the underlying activity is generally performed in the seller's residence, only the title is passed outside that residence."⁷ Exceptions were included to deal with

⁶ Staff of Joint Comm, on Tax'n, 99th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1986 at 917 (1987) (the "1986 Blue Book").

⁷ S. Rept. No. 99-313, 99th Cong. 2d Sess. at 329 (1986).

situations in which it is reasonable to expect a jurisdiction other than that of the seller's residence to subject the gain to taxation.⁸

Section 865(j) provides that regulations are to be prescribed to carry out the purposes of section 865, including the application of these provisions to losses from sales of personal property. The 1986 Blue Book states that, "[i]t is anticipated that regulations will provide that losses from sales of personal property generally will be allocated consistently with the source of income that gains would generate but that variations of this principle may be necessary."⁹

Generally symmetrical treatment of losses and gains from sales of personal property seems appropriate in light of the policies underlying section 865. Section 865 reflects the policy judgment that gains on dispositions of personal property should be treated as foreign sourced, thereby facilitating the crediting of foreign taxes, only where such gains are likely to be subject to foreign tax.¹⁰ Similarly, losses on dispositions of personal

⁸ These exceptions include section 865(f) (described in footnote 4 above), section 865(e)(1) (treating as foreign source gain the income from sales of personal property attributable to an office or other fixed place of business maintained in a foreign country if an income tax of at least 10% of the income from the sale is paid to the foreign country with respect to such income) and section 865(h) (treating gain that is sourced outside the United States under an income tax treaty as foreign sourced gain in a separate foreign tax credit category if the taxpayer so elects).

⁹ 1986 Blue Book at 923.

¹⁰ See 1986 Blue Book at 918.

property generally should be treated as foreign sourced, thereby reducing the opportunity to credit foreign taxes, only where such losses are likely to be taken into account by a foreign country to reduce the foreign tax base.

In view of the principle that was articulated in the legislative history of section 8650) and the considerable thought that was given to the implementation of this principle in the context of related party stock, in proposed regulation section 1.865-2, it is perplexing to us why proposed regulation section 1.865-1 adopts as the basic rule for losses on portfolio stock and other personal property an approach that is totally inconsistent with this principle.

Moreover, the rule of proposed regulation section 1.865-1 appears to produce inappropriate, harsh results for U.S. portfolio investors in international stocks and securities. Such investors typically will invest in a broad portfolio of stocks and securities of non-U.S. issuers. Dividend and interest income often will be subject to foreign withholding tax. These investors obviously are not insulated from market fluctuations, and may sell some portfolio

position stocks at a gain and other stocks at a loss. Whereas the gains would be treated as U.S. sourced, under the proposed regulation the losses would be foreign sourced and thus potentially would reduce the investors' creditable foreign taxes on dividend and interest income.¹¹

¹¹ In general, any foreign sourced net capital loss is taken into account in determining foreign sourced taxable income for purposes of the foreign tax credit limitation under section 904 to the extent such loss is taken into account in determining capital gain net income for the taxable year, subject to an adjustment for the capital gain rate differential. See section 904(b)(2)(B)(iii) and regulation section 1.904(b)-1(a)(3).

Furthermore, the proper application of the proposed regulation would require these investors to engage in complex computations in order to calculate their foreign tax credit in respect of their portfolio investments.

Accordingly, we recommend that the general rule set forth in proposed regulation section 1.865-2(a) be extended to portfolio stock and other personal property, subject to specified exceptions. It would appear to be appropriate for exceptions to this general rule to include (i) a dividend recapture exception that is designed to interdict portfolio stock investments that are intended to create foreign sourced dividend income but U.S. sourced loss and (ii) an anti-abuse rule similar to proposed regulation section 1.865-2(b)(3). We believe that an appropriate dividend recapture rule could provide for an allocation and apportionment of loss on the disposition of portfolio stock on the same basis as, and to the extent of, the amount of dividends on such stock (reduced by the amount of any interest or other expenses allocated against such dividends for purposes of applying section 904) if the taxpayer fails to satisfy the holding period set forth in section 246(c) in respect of such stock.¹²

In addition, pending the conclusion of the broader project referred to in the preamble, the regulations might reserve on the treatment of losses arising from financial instruments or integrated transactions that are structured with a view to distorting the source of income or loss by generating offsetting amounts of U.S. sourced loss and foreign sourced

¹² The dividend recapture rule of proposed regulation section 1.865(b)(1) may have the virtue of being simple (albeit imprecise in its application), but it does not appear to be well-suited to the portfolio investment context.

income. Losses from dispositions of stock of a regulated investment company or of an S corporation could be governed by regulation section 1.861-8 until further guidance is provided. As is the case under section 1.865-2, these rules should apply, at the election of the taxpayer, to all taxable years that begin after December 31, 1986.

In contrast to proposed regulation section 1.865-1, the foregoing recommendation would finally implement the directive in the legislative history of section 865(j) and would immediately conform the general treatment of losses on portfolio stock and other personal property to the treatment of (i) gains on such property and (ii) losses on related party stock, while enabling the Service to continue to evaluate whether exceptions need to be crafted for specific situations that are potentially subject to manipulation or abuse.

B. Related Party Stock (Prop. Reg. Section 1.865-2).

1. The General Rules. As indicated above, we support the general rule, set forth in proposed regulation section 1.865-2(a)(1), for allocating and apportioning loss from the disposition of related party stock in conformity with the manner in which gain from the sale of such stock would be allocated and apportioned. We also concur with the special rules of section 2(a)(2) (which treats loss as a foreign source loss if it is attributable to an office or other fixed place of business in a foreign country, gain would have been subject to tax in the foreign country, and the highest marginal rate is at least 10%) and section 1.865-2(a)(3) (which allocates

loss of a non-U.S. person on the disposition of a United States real property interest to reduce U.S. source income).

2. The Exceptions. We believe that the dividend recapture exception is an appropriate and sensibly crafted rule, although its simplicity may render it overinclusive or underinclusive in specific circumstances. We also concur with the anti-abuse rules. However, we question whether the consistency rule of proposed regulation section 1.865-2(b)(2) is consistent with the policies underlying section 865(f).

The consistency exception requires that loss on the disposition of stock of a foreign affiliate reduce foreign source income if, within the past five years, the seller or any member of its consolidated group recognized gain on the disposition of a foreign affiliate that was sourced under section 865(f). While the legislative history does not specifically discuss section 865(f), it appears that that provision was intended to enable a U.S. seller of a foreign affiliate, on an elective basis (by effecting the sale in the foreign country in which the affiliate conducts an active business that gives rise to a substantial portion of the affiliate's income), to treat gain on the disposition of the stock of the foreign affiliate as foreign source gain. It can reasonably be assumed that a seller would seek to take advantage of section 865(f) where the foreign country imposes a tax on the sale. In that event, the consistency rule of the proposed regulations has the potential to deprive such a seller of the benefit of section 865(f), on a haphazard and arbitrary basis, depending on whether it sells the stock of another foreign affiliate at a loss within five years. Moreover, the consistency rule does not appear to be necessary in order to

prevent abuse by a seller that arranges to have section 865(f) apply in a situation in which there is no foreign tax on the sale since the gain would be in the passive income category under section 904(d) and is therefore extremely unlikely to absorb otherwise unutilizable foreign tax credits.

Accordingly, we recommend that the consistency rule be deleted. If this recommendation is not adopted, the consistency rule should be limited so as to apply to loss on the disposition of foreign affiliate stock only to the extent of the amount of gain that was sourced under section 865(f) during the previous five years. The failure to provide such a limitation would not seem supportable, because there appears to be no justification for penalizing a taxpayer for taking advantage of an election specifically provided by Congress.

3. Prior Year Election.

We have two recommendations for simplifying the election to apply regulation section 1.865-2 to all open years that begin after December 31, 1986. First, the provision should be clarified and modified to provide that an amended return needs to be filed only for those taxable years in which (i) there was a sale of related party stock at a loss (thereby negating the possible suggestion in the proposed regulation that an amended return must be filed for all years beginning after 1986), (ii) the election results in a change in tax liability and (iii) the taxable years in question are not under audit. For those taxable years in which there was a sale at a loss but either there is no change in tax liability or the year is under audit, it should be sufficient to file the statement described in the proposed regulation, without filing an amended return. This modification would obviate the need to incur the potentially significant expense of preparing

and filing amended state income tax returns, which often are required to be filed upon the filing of an amended federal tax return even in the absence of a change in tax liability.

Second, it should be clarified that if an election is made in respect of a loss attributable to the worthlessness of stock in a particular year, the election will be respected even if it is determined that the stock is worthless in another year, thereby eliminating the necessity to file protective elections in other years or to rely on various mitigation provisions or special statute of limitation rules (e.g., sections 1311-1314 and 6511(d)).