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August 7, 2017
Report No. 1376

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Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
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The Honorable John Koskinen
Commissioner
Internal Revenue Service
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The Honorable William M. Paul
Acting Chief Counsel
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Re: *Letter on Notice 2017-38*

Dear Messrs. Kautter, Koskinen, and Paul:

This letter of the New York State Bar Association Tax Section responds to Notice 2017-38, which identified eight Department of Treasury ("Treasury") regulations issued in 2016 as potentially either imposing a substantial burden on taxpayers or adding undue complexity to the law. In light of the short time frame to provide comments pursuant to Notice 2017-38 and in an effort to assist Treasury in completing its analysis of the identified regulations, this letter generally summarizes and compiles the comments we have made previously.[1]

[1] The Tax Section is considering providing input on other regulations that we believe should be modified or eliminated to reduce unnecessary burdens on taxpayers, as requested in Executive Order 13777.

The Tax Section is appreciative of the hard work and dedication of the professionals in the Treasury's Office of Tax Policy and the Internal Revenue Service (the "Service"). The tax guidance issued by Treasury and the Service is thoughtful and well developed, providing certainty for taxpayers and their advisors.

I. Background

Executive Order 13789 ("EO 13789"), signed by President Trump on April 21, 2017, called for Treasury to review all "significant tax regulations" issued on or after January 1, 2016, and to identify in an interim report those that impose undue financial burden, add undue complexity, or exceed statutory authority.

As a result of this study, Treasury issued Notice 2017-38 on July 7, 2017, identifying eight regulations issued in 2016 that Treasury believes may impose a substantial burden on taxpayers or may add undue complexity to the law.[2] No regulations were identified as exceeding statutory authority. Of the listed regulations, the Tax Section previously has commented on four: [3]

- Proposed Regulations under Section 2704 on Restrictions on Liquidation of an Interest for Estate, Gift and Generation-Skipping Transfer Taxes (REG-163113-02)
- Temporary Regulations under Section 752 on Liabilities Recognized as Recourse Partnership Liabilities (T.D. 9788)
- Final and Temporary Regulations under Section 385 on the Treatment of Certain Interests in Corporations as Stock or Indebtedness (T.D. 9790)[4]
- Final Regulations under Section 367 on the Treatment of Certain Transfers of Property to Foreign Corporations (T.D. 9803)

As a general matter, our reports were drafted from the perspective that the regulations would be adopted in some form, after appropriate comment and review. The reports identify and discuss areas of concern that are consistent with those identified in

[2] The Notice requested comments by August 7, 2017.

[3] In addition, the following regulations were identified: Proposed Regulations under Section 103 on Definition of Political Subdivision (REG-129067-15); Temporary Regulations under Section 337(d) on Certain Transfers of Property to Regulated Investment Companies (RICs) and Real Estate Investment Trusts (REITs) (T.D. 9770); Final Regulations under Section 7602 on the Participation of a Person Described in Section 6103(n) in a Summons Interview (T.D. 9778); Final Regulations under Section 987 on Income and Currency Gain or Loss With Respect to a Section 987 Qualified Business Unit (T.D. 9794) .

[4] The Tax Section commented only on the proposed form of the regulations, which were broader in their scope of applicability but included substantially similar rules. We believe many of our comments on the proposed regulations remain relevant.

Notice 2017-38. Therefore, set forth below is a summary of the relevant parts of the prior reports as compared to the Treasury's observations in Notice 2017-38.

II. Identified Regulations

A. Proposed Regulations under Section 2704

As explained in Notice 2017-38:

> Section 2704(b) of the Internal Revenue Code provides that certain non-commercial restrictions on the ability to dispose of or liquidate family-controlled entities should be disregarded in determining the fair market value of an interest in that entity for estate and gift tax purposes. These proposed regulations would create an additional category of restrictions that also would be disregarded in assessing the fair market value of an interest. Commenters expressed concern that the proposed regulations would eliminate or restrict common discounts, such as minority discounts and discounts for lack of marketability, which would result in increased valuations and transfer tax liability that would increase financial burdens. Commenters were also concerned that the proposed regulations would make valuations more difficult and that the proposed narrowing of existing regulatory exceptions was arbitrary and capricious.

In NYSBA Tax Section Report 1358, *Joint Report on Proposed Regulations under Section 2704 of the Code*, we commended Treasury and the Service for exercising their regulatory authority to propose reform in connection with the tax valuation rules of Section 2704, and recommended changes to improve the administration of the rules and promote certainty. The Report observed that the Proposed Regulations provide almost no guidance regarding how an interest in an entity should be valued when certain "applicable restrictions" and "disregarded restrictions" are disregarded when determining fair market value of an interest in an entity, as required by the Proposed Regulations. To address this concern, the Report recommended that Treasury and the Service consider adopting one of the following standards to use in determining fair market value of an interest in an entity where a restriction is disregarded: (a) provide clear substitute assumptions that an appraiser must apply when valuing an entity interest; (b) provide that a gift occurs on formation of the entity; or (c) provide that the entity interest is not valued under the traditional willing-buyer-willing-seller test.

B. Temporary Regulations under Section 752

As explained in Notice 2017-38:

> These temporary regulations generally provide: (i) rules for how liabilities are allocated under Section 752 solely for purposes of disguised sales under Section 707 of the Internal Revenue Code; and (ii) rules for determining whether "bottom-dollar payment obligations" provide the necessary "economic risk of loss" to be taken into account as a recourse liability. Commenters stated that the first rule was novel and would unduly limit the amount of partners' bases in their partnership interests for disguised sale purposes, which would negatively impact ordinary partnership transactions. Commenters were concerned that the bottom-dollar payment obligation rules would prevent many business transactions compared to the prior regulations and suggested their removal or the development of more permissive rules.

The Tax Section generally does not agree with the comments cited above. NYSBA Tax Section Report No. 1307, *Proposed Regulations on the Allocation of Partnership Liabilities and Disguised Sales*, recommended that, solely for purposes of the disguised sale rules of Section 707(a)(2)(B), partnership liabilities generally be allocated in accordance with a portion of the rules governing the allocation of nonrecourse liabilities under Section 752.[5] This suggestion was generally adopted by the Temporary Regulations promulgated as part of T.D. 788. According to Notice 2017-38, commentators stated that this "rule was novel." Although the rule itself is novel, it is noteworthy that this rule simplifies the administration of the disguised sale rules and does not create a new regulatory framework; rather, it incorporates the well-understood rules under Treasury regulations section 1.752-3(a)(3) (relating to the allocation of "excess nonrecourse liabilities"). Moreover, we believe it was a reasonable change to the Treasury regulations in light of the development of commercial practices since the finalization of the original disguised sale regulations in 1992. The Notice also states that commentators claimed that this change "would negatively impact ordinary partnership transactions." What is "ordinary" is, of course, a matter of judgment and experience. While this rule has the effect of making it more difficult to use the partnership rules to extract cash from an asset on a tax-deferred basis, the disguised sale rules contain numerous exceptions and limitations that continue to provide taxpayers ample opportunity to combine their assets on a tax-deferred basis while appropriately limiting the ability to "cash out" of those assets without the recognition of gain.

The Report supported the provisions of the Proposed Regulations addressing so-called bottom-dollar guarantees, with certain modifications. We also recommended that if

[5] The Tax Section also submitted Report No. 1361, *Proposed and Temporary Regulations under Sections 707 and 752* .

the Service and Treasury determined that finalizing those provisions "would result in significant changes to the manner in which partnership deductions are allocated under Section 704(b) (applying traditional Section 704(b) principles)," consideration should be given to "seeking additional public comments before finalizing those provisions." Substantially all of our recommendations were adopted when the Proposed Regulations were issued as Temporary Regulations, although additional comments regarding the allocation of partnership deductions were not sought. The Notice states that commentators "were concerned that the bottom dollar payment obligation rules would prevent many business transactions compared to the prior regulations and suggested their removal or the development of more permissive rules." Although we do not have empirical data to support this assertion, we suspect that it is correct that the Temporary Regulations will prevent many transactions compared with the prior regulations. We, however, share the view of the government, as described in the preamble to the Temporary Regulations, that bottom-dollar guarantees "generally lack a significant non-tax commercial business purpose." Instead, in our experience, these types of guarantees were included in transactions to achieve tax-planning (i.e., tax-deferral) objectives. We do not believe this was what was intended by Congress when it instructed Treasury to adopt the "economic risk of loss" rules in 1984. Nevertheless, as is stated in the Report, we do not believe that the interaction between the rules addressing bottom-dollar payment obligations and the allocation rules under Section 704(b) is well addressed by the current regulations, including the Temporary Regulations. Therefore, we recommend that Treasury provide additional guidance in the near term to address these interactions.

C. Final and Temporary Regulations under Section 385

As explained in Notice 2017-38:

> These final and temporary regulations address the classification of related-party debt as debt or equity for federal tax purposes. The regulations are primarily comprised of (i) rules establishing minimum documentation requirements that ordinarily must be satisfied in order for purported debt among related parties to be treated as debt for federal tax purposes; and (ii) transaction rules that treat as stock certain debt that is issued by a corporation to a controlling shareholder in a distribution or in another related-party transaction that achieves an economically similar result. Commenters to the documentation rules criticized the financial burdens of compliance, particularly with respect to more ordinary course transactions. Commenters also requested a longer delay in the effective date of the documentation rules.[6] Commenters to the final transaction rules criticized the complexity

[6] In Notice 2017-36 (July 28, 2017), Treasury and the Service postponed the time for application of the documentation rules to debt issued on or after January 1, 2019 (rather than January 1, 2018, as previously provided).

associated with tracking multiple transactions through a group of companies and the increased tax burden imposed on inbound investments

NYSBA Tax Section Report No. 1351, *Report on Proposed Regulations under Section 385*, addressed the Proposed Regulations under Section 385 and made similar comments to those included in the Notice. We have not commented on the Final and Temporary Regulations under Section 385. We are grateful for Treasury's and the Service's efforts in considering and responding to our and others' comments on the Proposed Regulations, and making revisions in the Final and Temporary Regulations. We believe, though, a number of our comments on the Proposed Regulations continue to be relevant and recommend further consideration of our earlier report.

D. Final Regulations under Section 367

As explained in Notice 2017-38:

> Section 367 of the Internal Revenue Code generally imposes immediate or future U.S. tax on transfers of property (tangible and intangible) to foreign corporations, subject to certain exceptions. These final regulations eliminate the ability of taxpayers under prior regulations to transfer foreign goodwill and going concern value to a foreign corporation without immediate or future U.S. income tax. Some commenters stated that the final regulations would increase burdens by taxing transactions that were previously exempt, noting in particular that the legislative history to Section 367 contemplated an exception for outbound transfers of foreign goodwill and going concern value. Commenters also stated that an exception should be provided for transfers of foreign goodwill and going concern value in circumstances that would not lead to an abuse of the exception.

In NYSBA Tax Section Report No. 1222, *Report on Section 367(d)*, submitted in 2010, prior to the issuance of the Proposed Regulations, the Tax Section recommended that any revisions to the existing regulations should not subject foreign goodwill and going concern value to Section 367(d), stating, "we believe that the legislative history expresses the clear intention that goodwill and going concern value used in connection with a foreign trade or business should be eligible for non-recognition and that Section 367(d) should be administered to honor that intention unless and until superseding legislation has been enacted." This recommendation was not adopted by Treasury in the Proposed Regulations that were released five years later, based on what the Preamble described as difficulties in administering the foreign goodwill and going concern value exceptions in the then applicable regulations.

NYSBA Tax Section Letter No. 1337, *Proposed Section 367 Regulations: Elimination of the Foreign Goodwill Exception*, commented on the Proposed Regulations

and recognized the difficulties and noted: "All must acknowledge the correctness of the government's position that significant differences in the tax treatment between goodwill and going concern value on the one hand, and other customer based intangibles on the other hand, seems a prescription for disagreement and potential litigation much like that which preceded the enactment of Section 197 of the Code." The Report made comments similar to those cited in the Notice above. Under the Regulations, an incorporation of a foreign branch requires valuation of all branch assets as if they had been sold to an unrelated party, which can result in a burdensome valuation process. A taxpayer must elect to treat foreign goodwill as either a Section 367(a) asset (with current taxation) or a Section 367(d) asset (with a royalty taxation regime under Section 367(d)), and so the Report recommended "the introduction of some limited exceptions designed to preserve nonrecognition of foreign goodwill in demonstrably non-abusive contexts." Further, the Regulations require asset appraisals and the potential for indefinite royalty treatment (previously limited to twenty years) on self-regenerating assets, where transferred value is difficult to distinguish from subsequently accruing value, and so the Report recommended that Treasury and the IRS consider restoring the 20-year useful life limit to any deemed royalty under Section 367(d).

* * *

We hope that our comments are helpful to you. Please let us know if we can provide any further assistance.

Respectfully submitted,

Michael S. Farber, Chair

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