REPORT #654

TAX SECTION

New York State Bar Association

Letter Requesting Treasury

April 17, 1990

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TAX SECTION

New York State Bar Association

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April 17, 1990

The Honorable Kenneth W. Gideon
Assistant Secretary
Department of the Treasury
Room 3120
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Re: T.P. 8294

Dear Mr. Gideon:

We write to convey our strong objection to Reg. § 1.1502-20T and in particular to the issuance of this regulation as a temporary, rather than a proposed, regulation.

The scope of Reg. § 1.1502-20T is far broader than required to deal with the son-of-mirrors problem presented by Notice 87-14. This regulation, which will in many cases deny deductions for recognized economic losses, is in fact a fundamental change in the entire consolidated return and loss recognition systems. Having protected against son-of-mirrors problems by issuing Reg. § 1.337(d)-1T there would seem no reason why Reg. § 1.150 2-20T was not promulgated as a proposed regulation. This would have allowed taxpayers appropriate notice and opportunity for comment before this far reaching change became operative.

We urge that the Treasury, without awaiting the June 26th hearing, announce that:

FORMER CHAIRS OF SECTION
Howard O. Colgan, Charles L. Kades, Carter T. Louthan, Samuel Brodsky, Thomas C. Plowden-Wardlaw, Edwin M. Jones, Hon. Hugh R. Jones, Peter Miller, John W. Fager, John E. Morrissey Jr., Charles E. Heming, Richard H. Appert, Ralph O. Winger, Hewitt A. Conway, Martin D. Ginsburg, Peter L. Faber, Renato Beghe, Alfred D. Youngwood, Gordon D. Henderson, David Sachs, Ruth G. Schapiro, J. Roger Mentz, Willard B. Taylor, Richard J. Hiegel, Dale S. Collinson, Richard G. Cohen, Donald Schapiro, Herbert L. Camp, William L. Burke

(1) T.D. 8294 will, with the exception of Reg. § 1.337(d)-1T, be converted from a temporary to a proposed regulation and that any final regulation will not affect transactions undertaken before it becomes final;

(2) Reg. § 1.337(d)-1T will remain in effect until a further regulation is issued; and

(3) If Reg. § 1.1502-20T becomes final, all taxpayers filing consolidated returns will be allowed to revoke their elections without suffering the adverse consequences (i.e., loss of basis) required by Reg. § 1.1502-20T.

Furthermore, it should be announced now that any such permission will be granted early in the calendar year for which the election may be made so that a corporation that may want to avail itself of that permission will be able to take that decision into effect in planning its year's operations.

The root of our objection to the loss disallowance system embraced by Reg. § 1.1502-20T can best be seen by analyzing its effects on affiliated groups A, B, and C which purchased subsidiaries AS, BS and CS in 1987, in each case for $100. The basis of AS's and BS’s assets was zero and of CS’s assets was $100. In 1989, BS sold one asset for $25, recognizing a $25 gain and retaining the proceeds of sale. Each subsidiary operates at break-even and none makes any distribution. On June 30, 1990, A, B, and C each sells the stock of its subsidiary for $50, recognizing a $50 economic loss.

Reg. § 1.1502-20T denies a deduction for the $50 economic loss recognized by each affiliated group although: A engaged in no son-of-mirrors transaction and there is no possibility of loss duplication; any tax benefit from B's son-of-mirrors transaction could be eliminated by applying Reg. § 1.337(d)-1T and there is no possibility of loss duplication; and C engaged in no son-of-mirrors transaction and the value of any duplicated losses is limited because: C's loss is a capital loss; and the ability of the purchaser to use CS's losses is

limited by the SRLY rules, the built-in-loss rules and sections 269 and 382.[1]

The preamble to T.D. 8294 essentially gives two justifications for adopting the loss disallowance rule of Reg. § 1.1502-20T: it prevents los duplication and it is the "simplest" method of dealing with the son-of-mirrors problem.

Loss duplication has been a corollary of our non-integrated corporate tax system since 1913. Congress and the Treasury have adopted a series of specific measures limiting such benefits (e.g., Reg. § 1.1502-15, IRC §§ 269, 382). In that perspective it hardly seems appropriate to deal with the problem by adopting a regulation that is immediately effective with no prior public disclosure that this issue has become a major Treasury concern. It particularly seems inappropriate to adopt a draconian cure that would deny any deduction in a broad range of cases where there has been economic loss and either no possibility of loss duplication exists or the real economic value of the duplicated loss is very small.

It is at this point that the issue of the validity of Reg. 1.1502-20T looms. A regulation aimed at loss duplication is not authorized by section 337(d)'s grant of authority for "... such regulations as may be necessary to carry out the purpose of [General Utilities repeal]." We would also think that there is at least significant question about the validity of a regulation promulgated under section 1502 denying any deduction where there has clearly been economic loss and Congress has created a complex structure to deal with loss duplication issues.[2]

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[1] We would note also that if CS's $100 basis for its assets represents accumulated earnings and CS was not purchased from another affiliated group then there has been a duplicated tax on CS's earnings, which would match the possibility of duplicated loss when C sells CS.

[2] See e.g., American Standard, Inc. v. U.S., 602 F.2d 256, 261 (Ct Cl. 1979); Comm'r v. General Machinery Corp., 95 F.2d 759 (6th Cir. 1938); see also Kanawha Gas and Utilities Co. v. Comm'r, 214 F.2d 685 (5th Cir. 1954); Corner Broadway Maiden Lane, Inc. v. Comm'r, 76 F.2d 106 (2d Cir. 1935).

We find the rally to the banner of simplification to justify a rule as sweeping as Reg. § 1.1502-20T less than convincing.[3]

We believe further dialogue could produce an administratively sound and simple system that would deal with son-of-mirrors transactions, without the drastic side effects of Reg. § 1.1502-20T. There would seem more than adequate time for such dialogue since an extension of the effective period of Reg. § 1.337(d)-1T could provide adequate protection against most son-of-mirrors transactions.

Reg. § 1.1502-20T raises far more significant issues than are presented by the son-of-mirrors problem. It would seem to represent a step in a much broader effort to restructure the entire consolidated return and loss recognition regimes. If that is indeed Treasury's purpose, we would have thought that proper respect for the administrative process, the virtues of full disclosure and proper compliance with the Administrative Procedure Act would have given Treasury pause before attempting to bring about this change without adequate public notice and debate. We would think this particularly appropriate since this rule will have a major adverse effect on the earnings and values of many United States corporations. (See Wall Street Journal, March 26, 1990, page A2).

Indeed, Reg. § 1.1502-20T implicitly raises questions about the loss recognition system applicable to corporations and their shareholders that would affect all corporations, whether or not filing consolidated returns. If those fundamental issues are to be addressed, we would think them more appropriate for Congressional decision, rather than for determination by regulation.

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[3] Neither Congress nor the Treasury has hesitated to adopt regimes relying on valuation and tracing where this has been thought necessary to protect the revenue: see, e.g., Reg. § 1.1502-15(a)(2)(i) (built-in losses); IRC § 56(g)(4)(H) (requiring appraisal of all assets for alternative minimum tax calculations after an ownership change) ; IRC § 384(c)(1)(A) (definition of "recognized built-in gain"); IRC § 1374(d)(1) (definition of "net unrealized built-in gain"); see also Notice 90-27 applying tracing to prevent avoidance of sections 382, 384, and 1374.

It is in light of these considerations that we urge you to take the steps proposed at the beginning of this letter. They would leave the revenue adequately protected and allow taxpayers to continue their business while appropriate thought and study are given to the wisdom of this very drastic overall revision of a major premise underlying the consolidated return regulations.

We expect, of course, to study this problem further and testify at the hearing on June 26th.

Very truly yours,

Arthur A. Feder, Chair

cc: The Honorable Fred T. Goldberg, Jr.
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