REPORT #655

TAX SECTION

New York State Bar Association

Letter on Simplification

April 23, 1990

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The Honorable Dan Rostenkowski
Chairman
House Ways & Means Committee
1102 Longworth Building
Washington, D.C. 20515

Re: Simplification

Dear Mr. Chairman:

This letter responds to your request for suggestions for simplification of the Internal Revenue Code. The Tax Section of the New York State Bar Association applauds your initiative and the initial simplification efforts with respect to civil penalties and the alternative minimum tax last year. We also commend the Committee for its activities with respect to Section 2036(c) and will provide you with our comments on the recently released draft proposal in the near future.

We believe statutory simplification should be one of the highest Congressional tax policy objectives. The Section has attempted to provide concrete assistance to the Internal Revenue Service in its simplification efforts with our proposed revision of the Temporary Section 752 Regulations (Tax Notes, Vol. 46, No. 9, page 1055 (February 26, 1990)) and other projects that are underway. We also intend to utilize the full resources of the Section to assist the efforts of Congress to attack the problem of statutory complexity.

Although the Section is not now prepared to make specific statutory proposals, we propose that your Committee carefully examine provisions in three areas other than those mentioned above -- individual taxation, corporate taxation and international taxation. Many simplifying steps could be taken in these areas. We intend to devote resources to the particular provisions described below because we believe substantial simplification may be accomplished in these areas for the benefit of many taxpayers and that we, as a Section, can be helpful in analyzing the merits of proposals in these areas.

We would particularly point out that many provisions we propose to address are at this time simply traps for the unwary which, we suspect, produce no revenue.

A. Individual Income Tax

1. Allocation of Interest Expense. The Tax Reform Act of 1986 left us with an extremely complicated system for determining the deductibility of interest incurred with respect to personal expenditures, qualified personal residence property, trades or businesses, passive activities, portfolio investments and other investments. We suspect that most individual taxpayers find compliance with the basic Regulations (see Temp. Reg. § 1.163-8T) with respect to these rules quite burdensome. There is a serious question whether workable interest allocation rules can even be devised with respect to pass-through entities. An effort should be made to determine whether the underlying statutory provisions can be drastically simplified, consistent with the basic policies underlying these provisions.

2. Bad Debt Losses. Advising a domestic taxpayer regarding the deductibility and carryover of bad debt losses now requires analysis of at least five different provisions, each incorporating seemingly

different standards as to the relationship of the losses to the business. IRC §§ 62(a)(1), 163(d), 166(d), 172(d) and 469(a)(1). It would be useful to consider whether these provisions could be simplified and coordinated.

B. Corporate Taxation

1. Elimination of The Section 338(e) and (f) Consistency Rules. The consistency rules under Section 338 are a major source of complexity in the corporate tax area. Treasury Department support of such rules in 1982 apparently assumed the existence of the General Utilities doctrine, later repealed by the Tax Reform Act of 1986. The question to be addressed is whether the remaining policy basis for the consistency rules justifies their complexity.

2. Elimination of the Collapsible Corporation Provisions of Section 341. Although the capital gains-ordinary income differential may return, the repeal of General Utilities has made the planning techniques to which- Section 341 was directed substantially less useful. Thus, it should be determined whether Section 341 continues to serve any real purpose or whether it can be eliminated.

3. Elimination or Substantial Revision of the Accumulated Earnings Tax and Personal Holding Company Taxes. Because the present maximum personal tax rate actually exceeds the maximum corporate rate, the role of these taxes should be reevaluated. Moreover, repeal of General Utilities makes the accumulation techniques these sections were intended to thwart much less important than when these sections were enacted.

C. International Taxation

1. Simplification of the Foreign Tax Credit. Although the policy rationale For the recent changes to the foreign tax credit is understandable, there is growing reason to believe that the rules have become completely unworkable even for the most sophisticated corporate taxpayers. We believe that the foreign tax credit rules, including the various basket rules, should be reconsidered with a view to determining whether significant simplification can be accomplished.

2. Reform of the Passive Foreign Investment Company Rules (Sections 1291 to 1295). The rules for the taxation of shareholders of passive foreign investment companies are a cause of substantial complexity. It may be possible to substantially simplify these rules without sacrificing their central legislative policies. In particular, consideration should be given to rationalizing the relationship between these rules and the controlled foreign corporation and foreign personal holding company rules. The role of the qualifying electing fund election in simplifying compliance may also merit further consideration.

3. Coordination and Simplification of Subpart F, Foreign Personal Holding Company, Passive Foreign Investment Company and Other Rules. In addition to rationalizing the relationship of the PFIC rules to Subpart F, consideration should be given to coordinating and rationalizing the Subpart F, foreign personal holding company and personal holding company rules generally. Such consideration should include coordination of the attribution rules with respect to these provisions. In addition, eliminating all but the PFIC and Subpart F rules should be considered, since these two rules taken together potentially provide a coherent and comprehensive

treatment of almost all deferral problems.

4. Elimination of the Section 1491 Excise Tax on Transfers of Appreciated Property to Foreign Partnerships, Trusts or Corporations. It is questionable whether these rules have ever operated in a rational manner. In any case, a strong argument can now be made that these rules are no longer necessary because of statutory developments in the taxation of partnerships (e.g. Section 704(c)), foreign trusts (e.g. Section 668), and transfers to foreign corporations (Section 367).

5. Elimination or Substantial Revision of FIRPTA. Repeal of General Utilities has as a practical matter eliminated the potential for foreign owners to avoid tax by liquidating U.S. corporations owning U.S. real estate. Thus, it may be questioned whether the substantial complexity of Sections 897 and 1445 and the compliance burden imposed in numerous transactions in which no foreign person is involved are justified by the limited revenue these provisions raise.

We emphasize that the provisions we have mentioned are only a small portion of these that could be significantly simplified. The Section and its members, as well as other interested parties, will no doubt make other significant proposals in the future. The process must begin somewhere, however, and we believe that study of these provisions, which taken together affect many taxpayers, could produce significant progress.

We also continue to believe that a substantial and systematic effort should be made to simplify the laws regarding qualified retirement plans and related employee benefit plans, which affect many businesses and individuals. The problems with the current system are summarized in the Report of the Special Committee on Pension Simplification of the New York State Bar

Association, "A Process Awry: Federal Pension Laws," (Tax Notes, Vol. 43, No. 4, page 463 (April 24, 1989)). That Report suggests that certain provisions are strong candidates for outright repeal, including the top-heavy rules (Section 416), and the minimum participation rules (Section 401(a) (26)). Several observers have also suggested that the rules regarding plan distributions could be rationalized and simplified significantly. It can be argued, however, that these problems would best be addressed in one comprehensive overhaul of the system after systematic study by representatives of all concerned groups. We do not, for that reason, recommend piecemeal reform of specific aspects of the pension system at this time. We would, however, be pleased to provide all possible assistance to you in analyzing any specific proposals for simplification of the employee benefit rules you may consider.

Finally, without addressing the overall policy merits of reintroducing a capital gains differential or indexation of capital gains, it is our view that the effect of these proposals on the complexity of the Code should be given significant weight. In this regard, we hope to provide you shortly with a report on indexation addressing, among other things, the complexities associated with such provisions.

Very truly yours,

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Chair

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