REPORT #731

TAX SECTION

New York State Bar Association

Comments on Notice 92-12

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TAX SECTION

New York State Bar Association

July 16, 1992

Office of Chief Counsel
Internal Revenue Service
P.O. Box 7604, Ben Franklin Station
Attention: CC:Corp:T:R (Regulatory Burden
Reduction Initiative), Room 5228
Washington, DC 20044

Dear Sirs or Mesdames:

At the April meeting of the Executive Committee of the Tax Section of the New York State Bar Association, I asked individual committee members to consider which regulations projects listed for closing or re-designation in Notice 92-12 should be left open, with particular reference to their particular areas of responsibility as Committee Chairs. Unfortunately, these comments were slow in being made, and therefore it was not possible to meet the June 30, 1992 deadline referred to in the Notice. At the end of June I therefore called Chief Counsel Shashy's office to advise him that we were unable to meet the deadline but that comments would be forthcoming shortly.

Attached is a compendium of such comments. It was prepared by Robert J. Levinsohn, who also is the author of certain portions of the report. Further contributors were Kenneth C. Edgar, Jr., Kenneth H. Heitner, Richard M. Leder, Dennis E. Ross, Joel Scharfstein and Kenneth R. Silbergleit.

I hope that the discussion in the report will be helpful to you.

Very truly yours,

John A. Corry

cc: Abraham N.M. Shashy, Esq.

U.S. citizens, to be subject to U.S. tax rules more unfavorable than those applicable to foreign corporations.

The Preamble quoted above is perhaps an indirect suggestion that, in the view of Treasury, section 936 dividends should themselves be subject to a separate foreign tax credit limitation. This has never been intended by Congress, even though the predecessors of section 936 have been in the law since 1921. If Congress intended s separate limitation for section 936 dividends, it would have provided for one, just as in the case of dividends from FSCs and DISCs. Unlike FSCs and DISCs, however, section 936 corporations are typically large, capital intensive operating companies with many employees. As a conceptual matter, there is no reason why such corporations should be treated any differently than controlled foreign corporations conducting manufacturing activities outside the United States for AMT purposes.

VI. CONCLUSION

The Proposed Regulations would be invalid if adopted because they are contrary to the statute. Moreover, they would add an additional layer of complexity by providing different rules for AMT purposes than are provided for regular tax purposes. Clearly this would violate the Treasury's emphasis on keeping regulations as simple as possible.

The reason the Treasury finds itself in the peculiar position of having to propose invalid regulations is because of its decision to treat dividends from a section 936 corporation as necessarily passive income. That decision must be reversed because it is inconsistent with the basic look-through approach incorporated in section 904 to allocate income of foreign operations conducted in subsidiaries to the various foreign tax credit limitation baskets. It is Treas. Reg. section 1.904-5(g) that needs correction, not the regulations under section 864(e).

Accordingly, we urge that the Proposed Regulations under section 864(e)(5)(A) be withdrawn and that the first sentence of Treas. Reg. section 1.904-5(g) be amended to include the word “dividends” before the word “interest.”

* * *

Thank you for your consideration of this matter. If you have any questions, please do not hesitate to call.

Sincerely yours,
William P. McClure
J. Roger Mentz

cc: The Honorable Fred T. Goldberg, Jr.
The Honorable Alan J. Wilensky
Marlin Risinger, Esquire
The Honorable Abraham NM. Shashy, Jr.
Robert E Culbertson, Esquire
Charles S. Triplett, Esquire

NYSBA OUTLINES REGULATIONS
PROJECTS THAT SHOULD
BE LEFT OPEN.
(Section 665 - Excess Distribution Definitions)

July 16, 1992

Office of Chief Counsel
Internal Revenue Service
P.O. Box 7604, Ben Franklin Station
Attention: CC:Corp:T:R (Regulatory
Redaction Initiative), Room 5228
Washington, DC 20044

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Very truly yours,

John A. Corry
New York Stile Bar

Association

cc: Abraham N.M. Shashy, Esq.

COMMENTS ON NOTICE 92-12, MARCH 26, 1992

Notice 92-12, relating to regulations projects that will be closed or re-designated, states that the underlying goal of the Treasury Department and the Internal Revenue Service is to reduce “die burden that oar tax system imposes on taxpayers and the public.” We submit that it is inconsistent with that goal to close any project involving regulations interpreting statutory provisions not clearly capable of being complied with on their face, particularly where regulatory elaboration is specifically called for either in the Internal Revenue Code itself or in the applicable Congressional committee reports. To the contrary, it an undue burden on taxpayers and their advisers to leave complex statutory amendments unexplained in regulations, and to force them to search for guidance to the meaning of the status in scattered committee reports not always readily traceable to specific statutory sections.[1]

Accordingly, we discuss below certain regulation projects listed in Part I of Notice 92-12 which we recommend should be removed from that list and maintained in active status.

CASE NUMBER PS-184-76, RELATINO TO CODE SECTIONS 665-668: These regulations would implement Subpart D of Part I, Subchapter J of the Code, relating to accumulation distributions by complex trusts. Subpart D was completely revised by the Tax Reform Act of 1976, with further amendments by the Revenue Act of 1978, the Technical Corrections Act of 1979, the Tax Reform Act of 1986, and the Omnibus Budget Reconciliation Act of 1990. Despite the lapse of 16 years since this major statutory change, no regulations have been issued under Subpart D since those promulgated under the significantly different provisions enacted in the Tax Reform Act of 1969.

One of the most important changes in the 1976 Act was to replace the two alternative methods of calculating the throwback tax on accumulation distributions formerly found in Code section 668 as enacted in 1969, the so-called “exact” and “short-cut” methods, with a single method, similar to the short-cut method, now appearing in section 667. Explanation of the complexities of the short-cut method took three pages in the 1969 Act regulations, section 1.668(b)-1A(c).

It should not require a significant allocation of Service resources to update the portion of the 1969 Act regulations under section 668 covering the short-cut method to conform them to the current throwback rules under section 667. The major change in this method in 1976 was to take as the base for the three-year average used in determining the increase in the beneficiary's tax attributable to the throwbacks not the three preceding years, but the three out of the five preceding years left after eliminating the two years in which the beneficiary had the highest and lowest taxable income. Another change (limited to domestic beneficiaries by the 1978 Act) was the elimination, except as to tax-exempt interest, of the treatment of thrown back income as having the same character in the hands of the beneficiary as in the hands of the trust Drafting an updated version of Reg. section 1.668(b)-1A(c) to provide a regulation under current section 667 that incorporates these changes should be a relatively simple undertaking.

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[1] Other operative sections which require the allocation of expenses to gross income include section 871 and 882 (dealing with effectively connected income of a foreign person).

On January 16, 1978, the Tax Section filed with the Service a report on Priorities for Regulations Projects which incorporated the recommendations of ten substantive committees of the Tax Section as to the regulations projects listed in the status report of the Legislation and Regulations Division of the IRS Office of Chief Counsel as of October 31, 1977. One of the projects commented on in the report by the Committee on Income of Estates and Trusts as belonging in the category of projects of the highest priority was No. 184-76, and we attach an extract containing the currently relevant portions of that report as Appendix A. We have expanded wove on the recommendation in paragraph (6) of the extract. We reiterate the remaining recommendations as having as much validity today as they did fifteen year ago.

It is troubling to find that, in the current Schedule J (Form 1041), “Trust Allocation of an Accumulation Distribution”, the Service states at the top of Part L “See the regulations under sections 663-668 of the Internal Revenue Code for definitions and special rules.” Trustees and their advisers who are required to attach Schedule J to Form 1041 and trust beneficiaries and their advisers who are required to attach Form 4970, “Tax on Accumulation Distribution of Trusts”, to their returns should have an up- to-date regulation to refer to and expand on the bare outline of the statute. Notice 92-12 states that one of the purposes of the Department and the Service is to “help reduce the time and resources that taxpayers devote to reviewing materials that are obsolete and may be misleading.” It would further this goal to complete the regulation project for Subpart D, and it would clearly derogate from it to leave the un-amended obsolete 1969 Act regulations in place. Insofar as concerns the need to “allocate resources by establishing priorities that meet the competing needs of taxpayers for regulatory guidance”, as mentioned in Notice 92-12, trusts make accumulation distributions with sufficient frequency to justify treating this project as one deserving priority.

We take the opportunity to call to your attention that our 1978 report on regulation priorities from the Committee on Income of Estates and Trusts also placed in the category of the highest priority two projects dealing with code sections added by the 1976 Act which appear to have been previously closed without regulations ever having been issued. There were Project LR-188-76, dealing primarily with Code section 644, and Project LR-187-76, dealing primarily with Code section 679. An extract containing the currently relevant portions of these portions of the report is also attached as Appendix B.

Review of the prior report gives us no reason to change the view there expressed that each of these sections of the statute contains numerous ambiguities which taxpayers are entitled to have clarified by authoritative regulations. Sections 644 and 679 were enacted to block tax avoidance through the vehicle of trusts. They should be given the same regulatory elaboration as other Code provisions added earlier or later, unless the Department and the Service regard them as dead letters, in which event they should seek their repeal.

* * *

The following are examples of regulations projects involving provisions where the statute or committee reports expressly indicate an expectation that there would be regulatory implementation.

CASE NUMBER EE-080-89, RELATING TO CODE SECTION 72(t): These regulations would provide guidance regarding the 10 percent additional tax on early distributions from qualified retirement plans imposed by Code section 72(t), as added by the Tax Reform Act of 1986, and amended by the Technical and Miscellaneous Revenue Act of 1988 and the Omnibus Budget Reconciliation Act of 1990. Code section 72(t)(4)(A) provides that if distributions are not subject to the additional tax because they are being made periodically for life or life expectancy and they are subsequently modified (except for death or disability) within 5 years or before age 59-1/2, "the taxpayer's tax for the 1st taxable year in which such modification occurs shall be increased by an amount, determined under regulations, equal to the tax" which would have been imposed but for the lifetime payment exception, plus interest for the deferred period.

This express delegation of regulatory authority to implement the pro vision is a statutory command which should be honored, and requires that regulations be issued at least as to this aspect of die 10 percent additional tax.

CASE NUMBER PS-047-90, RELATING TO CODE SECTION 216(e): These regulations would implement Code section 216(e), as added by the Technical and Miscellaneous Revenue Act of 1988 and amended by the Omnibus Budget Reconciliation Act of 1990, which provides that, "Except as provided in regulations, no gain or loss shall be recognized on the distribution by a cooperative housing corporation of a dwelling unit to a stockholder in such corporation if such distribution is in exchange for the stockholder's stock in such corporation and such exchange qualifies for non-recognition of gain under section 1034(f)."[1]

The Conference Report for the 1988 Act provides as follows with respect to this provision:

"It is expected that the Treasury Department will prescribe regulations providing reporting or other procedures to assure that the intended relief is provided only in cases where the house or apartment is in fact used by the taxpayer as his principal residence both before and after the distribution. Also, the Treasury Department may prescribe rules to assure that there is a full recapture of tax benefits (if any) that may have been claimed at the corporate level, to the extent the same benefits could not have been claimed by the shareholder if he had owned the house or apartment directly and used it as his principal residence."

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[1] This report reflects die comments on separate regulation projects of Kenneth C Edgar, Jr., Kenneth H. Heitner, Richard M. Leder. Robert J. Levinsohn, Dennis E. Ross, Joel Scharfstein and Kenneth R. Silbergleit. The principal draftsperson was Robert J. Levinsohn.

H.R. Rep. 100-1104, 1988-3 C.B. 473,732.

This clear expression of Congressional expectation that there will be regulatory elaboration of the statute should be complied with.[2]

CASE NUMBERS CO-079-87 (PROPOSED REGULATIONS) AND CO-117-86 (TEMPORARY REGULATIONS), RELATING TO CODE SECTIONS 311, 336 AND 337: These were to be the regulations implementing in general the repeal of the General Utilities doctrine in the Tax Reform Act of 1986 and the Technical and Miscellaneous Revenue Act of 1978, thus requiring corporations to recognize gain in most cases upon the distribution of appreciated property to shareholders in liquidating and non-liquidating distributions.

There are express delegations of authority to the Secretary to prescribe regulations varying the statutory provisions in Code sections 311(b)(3) and 336(d)(2)(B)(ii) and (Q. Further, Code section 337(d) directs that “The Secretary shall prescribe such regulations as may be necessary or proper to carry out the purposes of the amendments” embodying the General Utilities repeal, including regulations in two specific areas set forth in the statute.

With reference to Code section 336(d)(2)(B)(ii), which disallows any loss to a liquidating corporation on depreciated property acquired in a non-recognition transaction within 2 years before the date of the adoption of the plan of complete liquidations “except as provided in regulations,” the following appears in the Conference Report for the 1986 Ace

[2] On January 10, 1990, the Tax Section submitted comments to then Commissioner Goldberg as to certain issues that these regulations should address. A copy is attached as Exhibit C.

"The conferees intend that the Treasury Department will issue regulations generally providing that the presumed prohibited purpose for contributions of property two yean in aavance3 of the adoption of the plan of liquidation will be disregarded unless there is no clear and substantial relationship between the contributed property and the conduct of the corporation's current or future business enterprises. * * * * [Example omitted.]

"As another example, the conferees expect that such regulations would permit the allowance of any resulting loss from die disposition of any of the assets of a trade or business (or a line of business) that are contributed to a corporation. In such circumstance, application of the loss disallowance rule is inappropriate assuming there is a meaningful relationship between the contribution and the utilization of the corporate form to conduct a business enterprise, i.e., the contributed business, as distinguished from a portion of its assets, is not disposed of immediately after the contribution."

H.R. Rep. 99-841, 1986-3 CB. Vol. 4 at 201.

The drastic effect of the repeal of the General Utilities doctrine should be sufficient, in and of itself, to require revision of the pre-existing regulations under Subchapter C The express direction for the issuance of regulations in both the statute and committee report makes it even clearer that abandonment of any general regulation project in this area is inappropriate. We submit, therefore, that even if the temporary regulation project is to be closed, the proposed regulation project should be continued.[3]

[3] Probably should read less than two years in advance".

CASE NUMBER CO-099-88, RELATING TO CODE SECTION 384: These regulations would provide guidance regarding Code section 384, as added by the Revenue Act of 1987 and amended by the Technical and Miscellaneous Revenue Act of 1988. This section limits a corporation's ability to offset gains that accrued prior to a merger or acquisition against pre-acquisition losses of a second corporation.

In Code section 384(c)(6) and (8) there are express delegations of authority to provide in regulations for variations from the statutory provisions, and section 384(f) provides expressly as follows:

“The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this section, including regulations to ensure that the purposes of this section may not be circumvented through -

(1) the use of any provision of law or regulations (including subchapter k of this chapter), or

(2) contributions of property to a corporation.”

The Conference Report for the 1987 Act provides in relevant pan as follows:

“The Treasury Department has regulatory authority to prevent the avoidance of the purposes of the provision through the use of any provision of the Code or regulations, including the provisions of subchapter K. For example (and without limitation), regulations may prevent the use of the so-called 'ceiling rule' of section 704(c) of the Code effectively to allocate built-in gain attributable to a partner to another partner which is a loss corporation. In such circumstances, die Treasury Department shall provide an appropriate mechanism for taking the built-in gain into income without permitting the use of such kisses. Regulations pursuant to this authority shall not be effective for any transaction prior to the issuance of additional guidance by the Treasury Department relating to ft) the mechanism to be employed for taking built-in gain into income and (ii) the types of transactions that will be subject to the provision.

“For purposes of determining whether the 25 percent built-in gain threshold of section 382(b) is satisfied, it is expected that any contribution of property with any purpose of avoiding the threshold will be disregarded. The Treasury Department may prescribe any more specific rules that may be necessary to prevent the evasion of the purposes of this section through contributions of property to the corporation.”

H.R. Rep. 100-495, 1987-3 CB. 193, 253-4.

The complexity of section 384 would warrant regulatory explication even in the absence of the express direction for the of regulations in the statute and committee report. The latter should make it clear that the closing of this regulation project is inappropriate.

CASE NUMBER EE-L64-86, RELATING TO CODE SECTION 409 AND RELATED SECTIONS: This project was to prepare proposed regulations setting forth the rules for Employee Stock Ownership Plans as affected by the Tax Reform Act of 1986. Although much of Code section 409. relating to tax credit ESOPs, la obsolete, significant portions of h are still applicable to ESOPs as defined in Code section 4975(e)(7). The regulations under the latter section, section 54.4975-11, were last amended in 1978, and do not reflect the major changes enacted in the Revenue Act of 1978 and subsequent legislation. No regulations have ever been proposed or promulgated under section 409, originally enacted in the Revenue Act of 1978, or under the correlative provisions of section 401(a)(28), as added by the Tax Reform Act of 1986.

The statutory provisions covering ESOPs are a jumble of scattered Code sections, some currently applicable and some not with numerous complicated cross references. A cohesive set of up-to-date regulations is clearly required to enable taxpayers and their advisors to find their way around this statutory morass.

In addition, there are a number of Code sections of current application which contain specific references to regulatory implementation:

Code section 401(a)(28)(B)(ii)(n), dating from the Tax Reform Act of 1986, provides, as one alternative requirement for the portion of a participant's account as to which he may elect to direct the investment, that the plan must offer at least three investment options not inconsistent with regulations prescribed by the Secretary” to each participant making the election.

Code section 409(e)(3), as amended by the Tax Reform Act of 1986, relating to an employer which does not have a registration-type class of-securities, requires that the plan must entitle each participant to direct the exercise of voting rights, under employer securities allocated to his account with respect to certain corporate matters specified in the statute, “or such similar transaction as the Secretary may prescribe in regulations.”

Code section 409(h)(4), as added by the Economic Recovery Tax Act of 1981, provides that the distribution requirement with respect to employer securities which are not readily tradable may be satisfied if the employer provides a put option to the participant for at least 60 days following the date of distribution and, if the option is not exercised within such period, “for an additional period of at least 60 days in the following plan year (as provided in regulations promulgated by the Secretary).”

Code section 409(1)(3), as amended by the Technical Corrections Act of 1979, relating to non-callable preferred stock which may be treated as employer securities under certain circumstances, provides that preferred stock shall be treated as non-callable, “under regulations prescribed by the Secretary,” if, after the call, the holder of the securities has a reasonable opportunity to convert the securities to common stock. See Senate Report 96-498, 1980-1 GB. 317,329, which goes on to state:

> “The committee also intends that preferred stock will be treated as non-callable if, pursuant to the call the holder of the securities receives solely employer securities in exchange for the securities.”

These specific statutory directions for the promulgation of regulations underscore the necessity for retaining in active status the regulation project relating to ESOPs.

CASE NUMBER PS-265-76, RELATING TO CODE SECTION 706(d): This project relates to Code section 06(d), as added by the Deficit Reduction Act of 1984 and Derided by the Tax Reform Act of 1986, which provides the methods of allocating partnership items to partners whenever a partner's interest varies during the partnership able year.

Code section 706(d)(1) expressly delegates to the Secretary the power to prescribe by regulations the methods to be used, so that the statute would not seem operative in the absence of regulations. There are further delegations of authority to vary or add to the statutory provisions in section 706(d)(2)(A), (2)(B)(iv) and (3)

The Conference Committee report regarding these so-called retroactive allocation provisions stated that with respect to the monthly convention explicitly provided in the Senate bill on an elective basis for determining the varying interests of the partners, ". . . the conferees understand that the Secretary will provide for a monthly convention by regulation: thus, the statutory provision adopted by the Senate is unnecessary. Under this convention, partners entering after the 15th day of a month will be treated as entering on the first day of the following month and partners entering during the first 15th days of a month will be treated as entering on the first day of the month. Further, the conferees note that the Secretary may provide for other conventions and may deny the use of any convention when the occurrence of significant, discrete events (e.g., a large, unusual gain or loss!) would mean that use of a convention could result in significant tax avoidance." HJL Rep. 98-861, 1984-3 C.B. Vol. 2 at 838.

The need for regulations under section 706(d) both to make this important statutory provision operative and to carry out the Congressional understanding as to its implementation is obvious. This project should not be closed.

CASE NUMBER PS-024-90 RELATING TO CODE SECTION 708(b)(1)(B): These would be temporary regulations coordinating Code section 704(c)(1)(B) as added by the Revenue Reconciliation Act of 1989 and Code section 708(b)(1)(B) (relating to deemed terminations of partnerships). Code section 704(c)(1)(B) provides that, under regulations prescribed by the Secretary, gain or loss is recognized to the contributing partner (up to the amount of pre-contribution built-in gain or loss) in cases where property contributed by a partner to a partnership is distributed to another partner within 3 years of contribution. The legislative history of section 704(c)(1)(B) indicates that it is intended that a deemed termination of a partnership under section 708(b)(1)(B) would not trigger gain or loss under section 704(c) but that the deemed termination should also not result in a shifting of pre-contribution built-in gain or loss away from contributed property to other partnership property. See Senate Finance Committee Report to P.L. 101-239 quoted at 92-7 CCH Standard Federal Tax Reports paragraph 23,420.07. Guidance is required as to the proper mechanism for effecting this intent While this issue may be property addressed in the upcoming proposed regulations under Code section 704(c), Case Number PS-164-84, if it is not, either the existing temporary regulations project under Case Number PS-024-90 should be continued or a new proposed regulations project under Code sections 704(c) or 708 should be initiated.

CASE NUMBER INTL-986-86, RELATING TO CODE SECTIONS 876 AND 931: These sections relate to the taxation of residents of specified possessions of the United States under amendments made by the Tax Reform Act of 1986. Code section 931(d)(2) and (3) provides explicitly that the determinations of whether income is derived from sources within, or is effectively connected with the conduct of a trade or business within, any specified possessions, and whether an individual is a bona fide resident of such possession, “shall be made under regulations prescribed by the Secretary.”

The Senate Finance Committee Report for the 1986 Act states as follows:

“The bill delegates to the Secretary of the Treasury the authority to prescribe regulations to determine whether income is sourced in, or effectively connected with the conduct of a trade or business in, one of these possessions, and to determine whether an individual is a resident of one of these possessions. The committee anticipates that the Secretary will use this authority to prevent abuse. For example, the committee does not believe that a mainland resident who moves to a possession while owning appreciated personal property such as corporate stock or precious metals and who sells that property in the possession should escape all tax, both in the United States and the possession, on that appreciation. Similarly, the committee does not believe that a resident of a possession who owns financial assets such as stocks or debt of companies organized in, but the underlying value of which is primarily attributable to activities performed outside, the possession should escape tax on the income from those assets. The Secretary should treat such income as sourced outside the possession where the taxpayer resides (and any covered over taxes attributable to this income should not be re-bated to the taxpayer). Similarly, where appropriate, the

Secretary may treat an individual as not a bona fide resident of a possession.”

Sen. Rep. 99-313, 1986-3 C.B. Vol. 3 at 481.

The Treasury Department should carry out the Congressional mandate to provide regulations implementing these provisions. The population of the affected possessions, Guam, American Samoa and the Northern Mariana Islands, may be small, but their residents should not be left at sea as to their tax regime under a statute which requires regulatory elaboration to be properly operative. Moreover, the Congressional concern over abuse by mainland residents and others should be addressed. Accordingly, this project should be continued.

* * *

The following is an example of a further regulations project which relates to a statute not containing express references to regulatory interpretation, but involving sufficient complexity to require updated regulations.

CASE NUMBER CO-074-87 RELATING PRIMARILY TO CODE SECTION 368: This was to be the project providing regulations under the amendments to Subchapter C by the Bankruptcy Tax Act of 1980, primarily involving the addition to the Code of section 368(a)(1)(G) and (3), relating to bankruptcy and other insolvency reorganizations. The Senate Finance Committee Report on the provisions of the Bankruptcy Tax Act dealing with corporate reorganizations coven 4 pages in the Cumulative Bulletin. Sen. Rep. 96-1035, 1980-2 CJB. 620,637-40. Although there are no express references to the need for regulations in the statute or Committee Report, the latter includes a number of interpretations which go beyond the literal statutory provisions. See, for example, the following in the Senate Report:

> "It is expected that the courts and the Treasury will apply to 'G' reorganizations continuity-of-interest rules which take into account the modification by P.L. 95-598 of the 'absolute priority' rule. As a result of that modification, shareholders or junior creditors, who might previously have been excluded, may now retain an interest in the reorganized corporation."

1980-2 CB. at 639.

Code section 368(a)(1)(G) has been with us for nearly 12 yean, during which taxpayer and their advisors have had to straggle without regulatory elaboration. As the length of the Committee Report indicates, there are a number of areas requiring authoritative administrative interpretation to expand upon the relatively brief provisions of the statute. Although not of the highest priority, we believe this project deserves to be kept in active status until it can be given proper attention.

* * *

In the time available, it has not been possible to make an exhaustive study of all the projects listed for termination in Part I of Notice 92-12. The foregoing is intended rather to be merely illustrative of the type of projects we believe should not be closed because it cannot be said that they are no longer needed, but instead should be maintained in active status until they can be finalized in accordance with such priorities as the Treasury Department and the Service establish to meet the competing needs of taxpayers for regulatory guidance. The general principles set forth at the beginning of this report should be applied in determining whether there are other projects which should be removed from the list to be closed in Notice 92-12.

Exhibit A

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

COMMITTEE ON INCOME OF

ESTATES AND TRUSTS

Report on priority of Regulations Projects

Category 1. Projects of the highest priority.

* * *

(b) Project LR-184-76, TRA Sections 701(a)-(d), (f), 1014, Code Sections 665-668:

These sections establish the new provisions for the tax treatment of distributions of accumulated trust income subject to the throwback rules. The revised provisions are applicable to distributions in taxable yean beginning after December 31,1975, and thus are applicable to returns for which the filing deadline has already passed. They make major changes from pre-existing law requiring amplification by regulations, which clearly must be given the highest priority. Among the problems such regulations should cover are the following:

* * *

(4) The legislative history states that the new exemption from the throwback rules for income accumulated prior to a beneficiary's 2lst birthday “is not to apply in the case of distributions covered under the multiple bust rules.” General Explanation at 162. The Intended result is not apparent from the face of the statute, which states the exception in terms of a cross reference. Code section 665(b). Presumably, the intent is to limit the minority exemption to accumulations in 2 mists where there are accumulations for a minor in 3 or more trusts. The regulations should clarify this-point.

(5) The amended accumulation trust provisions limit a beneficiary's reduction of his tax on throwbacks in most cases to the taxes previously paid by not more than 2 trusts, where income was accumulated for him in the same year by 3 or more trusts. Code section 367(c). Likewise, the exemption from the throwback rules of income accumulated prior to a beneficiary's 21st birthday is barred in multiple trust situations, as discussed in Paragraph (4) above, code section 663(b). The regulations should clarify whether these multiple trust rules are applicable where multiple trusts having certain characteristics are required to be consolidated and treated as one trust for purposes of Subchapter J by Regs. section 1.641(a)-0(c). It would appear that, where trusts are taxed as one trust for purposes of computing their own tax, they should not be treated as multiple trusts for purposes of computing their beneficiaries' taxes under the throwback rules.

(6) In view of the elimination of the “exact” method and the revisions in the “shortcut” method of taxing accumulation distributions, a revised example is required in the regulations showing in detail how the throwback calculations are made under the amended law.

(7) Section 1014 of the Tax Reform Act enacts new section 668 of the Code, under which the United States beneficiary of a foreign trust not taxed under the grantor trust provisions described in paragraph (c) below is subjected to a 6% non-deductible interest charge on the tax on distributions of accumulated income as computed under the throwback rules. This interest charge applies to distributions in taxable yean beginning after December 31, 1976, so that the immediate promulgation of regulations is not as urgent as in the case of other provisions discussed in this report. However, the computation of die interest charge is complex where a distribution consists of amounts accumulated in more than one year, and regulations should provide detailed examples as to how the calculations should be made.

* * *

Exhibit B

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

COMMITTEE ON INCOME OF

ESTATES AND TRUSTS

Report on Priority of Regulations Projects

Category 1. Projects of the highest priority.

(a) Project LR-188-76, TRA Section 701(e), Code Sections 644,641(c):

Section 644 imposes on mists a tax at the transferor's tax brackets to the extent of appreciation existing at the time property is transferred inter vivos to a mm after May 21, 1976, when such property is sold by the mm at a gain within 2 years after the transfer and the transferor is living at the time of the sale. This section is potentially applicable to any trust taxable year ending on or after May 31, 1976, and consequently already may be applicable to returns for which the filing deadline has long since passed. The section introduces a new and unfamiliar concept into the tax law and is of substantial complexity. The necessity of assigning the highest priority to this regulation project is obvious. In particular, the following problems must be dealt with in regulations:

(1) The statute provides expressly that the portion of a trust's includible gain subject to the provisions of sections 1243 and 1 shall be determined in accordance with regulations. Code section 644(c)(2). Such regulations should take into account possible variations in treatment depending on the relation of the fair market value of depreciable property at the time it is initially transferred in trust to the transferor's unadjusted basis, and to the amount realized by the mist on the sale of the property. It would appear that depreciation in the hands of the trust should not ordinarily be taken into account in computing the recapturable portion of the gain taxable at the transferor's brackets, except to the extent that such depreciation would otherwise escape recapture, as might be the case where the total gain realized exceeds the depreciation allowable while the transferor held the property, but the amount realized on the sale is less than the fair market value at time of transfer, so that the post-transfer depreciation is more then the portion of the gain taxable to the trust under the normal rules.

(2) According to the legislative history. "Where the trustee of the mist does not have sufficient information about the transferor to compute the tax on the includible pin, it is expected that the Internal Revenue Service will issue regulations

under which the trustee of state in the tax return that he does not have sufficient information and that, in such a case, the Service will compute the tax attributable to that gain.”

General Explanation of the Tax Reform Act of 197 Prefect by the Staff of the Joint Committee on Taxation,[1] at 1c.

Among the problems such regulations must deal with is the extent to which, consistent with the confidentiality of the grantor's tax returns, the Service will disclose die basis of its computation to the trustee; whether the trustee will be given an opportunity to challenge that computation; and bow adjustments resulting from an audit of the grantor’s income tax returns will be taken into account. See General Explanation at 164.

* * *

(4) The statute provides that the section 644 tax is imposed on the trust for its taxable year which begins with or within the taxable year of the transferor in which the sale or exchange occurs, even if this is after the taxable year of the mm in which the sale or exchange occurs. Code section 644(a)(3). Nevertheless, the legislative history appears to indicate that, to cover cases where the trust terminates prior to the end of the trust taxable year in which the gain is realized but after a new taxable year of the transferor has commenced, “it is contemplated that the Treasury will issue regulations making such gain reportable in the return of the mm for in last taxable year.” General Explanation at 164. Since this point is not covered in any way by the statute, it would appear here as well that at least temporary regulations should be issued promptly.

[1] Hereinafter, "General Explanation."

* * *

(c) Project LR-187-76, TRA Section 1013, Code Sections 679,643(a)(6)(C),(D),6048, 6677:

Section 679 provides that a United States person transferring property to a foreign mm inter vivos after May 21,1974, is subject to tax under the grantor trust rules as to the portion of the mm attributable to such property so long as he is alive, during any taxable year of the grantor ending after December 31, 1973, in which there is an actual or potential United States beneficiary of any portion of the trust. If a foreign accumulation mm with a U.S. grantor initially has no U.S. beneficiary or potential beneficiary, the U.S. grantor will be taxed on all the previously income in the year any such beneficiary first becomes a U.S. citizen or resident

In the case of a foreign mm not subject to the new grantor mm provisions, a United States beneficiary will be taxed on any income accumulated and later distributed by the trust under throwback rules that are, with certain exceptions, the same as those applicable to beneficiaries of domestic accumulation trusts. In the case of foreign accumulation trusts, any capital gains are treated as included in accumulation distributions and are taxed to the beneficiary as if they were ordinary income. These provisions are generally applicable to taxable year beginning after December 31, 1975.

Section 6048(c) provides that each United States person subject to tax under the grantor trust rules of section 679 must make an annual information return with respect to the foreign trust for his taxable year. Section 6677(a) subjects United States grantors to civil penalties for failure to file returns required by section 6048. These provisions apply to taxable yean ending after December 31, 1975.

The grantor trust provisions of section 679 import into the Internal Revenue Code the entire new concept of taxing an individual on the income of a trust over which he retains no control. Under certain circumstances, it also subjects him to large potential tax liabilities as a result of actions of individuals over whom he has no control and of whose existence he may not even be aware. The provisions are already in effect for taxable yean as to which the filing deadline has passed. Clearly, the issuance of regulations is a matter of the highest priority. The following are among the problems which must be dealt with in such regulations:

(1) The drastic tax consequences imposed by the new law place a premium on knowledge by a grantor whether he is transferring property to a “foreign trust” Yet the circular definition in Code section 7701(a)(31)[2] provides no guidance, and there are no regulations under die latter section. Under present law, the matter is left to decision on a case by case basis. See, e.g., B.W. Jones Trust v. Commissioner, 132 F.2d 914 (4th Cir. 1943); Rev. Rul. 60-181, 1960-1 C.B. 257. The provision by regulation of more precise content to the term “foreign trust” would seem appropriate. A series of examples similar to the one now contained in Reg. section 1.643(a)-6(b), Example (1), might be helpful Consideration might be given to providing by

[2] The term "foreign trust" means a trust "the income of which, from sources without the United States which is not effectively connected with the conduct of a trade or business within the United States, is not includible in gross income under subtitle A."

regulation that a trust which includes all income from sources without the United States in gross income in its income tax returns, and all of whose beneficiaries take a position consistent with such inclusion on their income tax returns, shall be deemed not to be a foreign trust for purpose of section 679.

(2) The regulations should indicate whether a nonresident alien individual married to a citizen or resident of the United States who makes the election to be treated as a resident of the United States under Code section 6013(g) will be considered to be a "United States person" [as defined in section 7701(a)(30)] for purposes of ascertaining whether a foreign trust has a United States beneficiary under section 679(c). The legislative intent appears to have been that an individual making the section 6013(g) election is to be treated as a United States resident for all purposes of the income tax laws. See General Explanation at 216. See also die clarification of section 6013(g) in section 2(t)(15) of the Technical Corrections Act of 1977 as passed by the House of Representatives, as explained in Part m A, Section 20 m, of the House Ways and Means Committee Report H.R. Rep. No. 95-700, 95th Cong., 1st Sess. at 46.

(3) The statute is susceptible of the interpretation that any potential beneficiary of trust accumulations, no matter how remote or contingent his interest, who is a United States person, will subject die grantor to the strictures of section 679. It may be appropriate for the regulations to exclude potential beneficiaries from consideration where their interests fall below some stated de minimis rule.

(4) Even if a foreign trust initially baa no actual or potential United States beneficiary, in any year that any actual or potential beneficiary becomes a United States citizen or resident the grantor becomes subject to section 679, including the requirement of section 679(b) that he include in his income all the previously accumulated income attributable to his transfer to the trust. See General Explanation at 222 n. 9, 223 n. 10. The regulations should set forth rules prescribing the extent to which a grantor will be chargeable with notice that an actual or potential beneficiary of a trust has become a United States citizen or resident, or has made an election under section 6013(g) to be treated as a United States resident, if that provision is relevant as discussed in paragraph (2) above. Perhaps a form could be devised for an annual certification by trust beneficiaries (or by their parents or guardians) that they have Dot become United States citizens or residents and have not elected to be treated as residents. Such a form could be attached by the grantor to his income tax return as a basis for establishing the inapplicability of section 679. If no de minimis rule is to be established as suggested in paragraph (3) above, the regulations should provide for the possibility that there may be potential United States beneficiaries who have come into being or whose status has changed since the creation of the trust, of whose existence the grantor is not aware. Such a situation might arise, for example, in a case where a nonresident alien of the United States, who is a remote, contingent beneficiary of a foreign trust created by a United States grantor, while traveling in the United States gives birth to a child (who becomes an even more remote, contingent beneficiary of the trust) who is automatically a citizen of the United States even though he or she does not thereafter reside in the United States, and is therefore a “United States beneficiary” for purposes of section 679.

(5) The Senate Finance Committee Report stated that "For purposes of determining the portion of a trust over which the U.S. grantor is treated as owner, loans to the trust by the grantor or by any other person shall be disregarded." S. Rep. No. 94-938, supra, at 218. At the same time, footnote 7 stated, inconsistently:

"For example, if a U.S. person transfers $10 to a foreign trust having U.S. beneficiaries, and also lends $90 to that trust, he shall be treated as the owner of trust income attributable to $100."

S. Rep. No. 94-938 at 218 n. 7. In the General Explanation, the sentence in the text was changed to read:

"For purposes of determining the portion of a trust over which the U.S. grantor is treated as owner, loans to the mist by the grantor may be treated as transfers of corpus."

General Explanation at 221. Footnote 6 at page 221 of the General Explanation is the same as footnote 7 at page 218 of the Senate Finance Committee Report, except that, in the General Explanation, the last part of the sentence is changed to read:

"be <u>may</u> be treated as the owner of trust income attributable to $100." (Underscoring added.)

Presumably what is intended is that loans by a United States grantor to a foreign trust, where there is more than one grantor, are to be included in determining the portion of the trust of which he is treated as owner. The revised text in die General Explanation is consistent with this interpretation. However, the significance of the change from "dull" to "may" in the footnote is not clear. Regulations are thus needed to clarify the treatment of loans.

(6) Section 679(a)(2)(B) provides an exception to the application of section 679 in the case of a sale or exchange of property at fair market value in a “transaction” in which “all” of the transferor’s gain is realized at the time of transfer and either is recognized at such time, or is returned on the installment method under section 453. The significance of the words “transaction” and “all” requires clarification. The regulations should indicate whether the exception will apply where a transferor, at or about the same time, transfer some property to a foreign trust without consideration, and other property in a sale at full fair market value. If emphasis is to be given to the word “transaction” in the statute, transfers for consideration could be treated separately from simultaneous transfers without consideration, and the exception given effect with respect to the portion of the trust attributable to the transfer at fair market value. If, on the other hand, the greater weight were to be given to the word “all”, the statute might be interpreted as preventing the application of the exception unless all property transferred at or about the same time was in a sale at full fair market value. The legislative history appears to lean in the direction of the transactional approach. See General Explanation at 222.

(7) If the transactional approach to section 679(a)(2)(B) is to apply, so that transfers to a foreign trust without consideration will not infect other transfers that are for full consideration, it may be desirable to give consideration to whether the regulations should provide further detail as to how the portions of the trust attributable to property which is and is not subject to section 679 are to be determined. It is not

clear that the pre-existing attribution provisions in Reg. section 1.671-3 will necessarily be adequate to cover the problems arising under section 679.[3]

(8) A literal application of the provisions of section 679(a)(2)(B) might make the exception inapplicable if the transferred property has not appreciated. The policy of the exception would appear to be satisfied if property is sold at fair market value, even if the sale is not at a gain, and it would seem appropriate for the regulations to take such a position. Likewise, since the exception in section 679(a)(2)(B) cannot apply to a transfer of cash, a literal reading of section 679 would make it applicable to any United States person who PURCHASES property from a covered foreign trust for cash at fair market value, even if he had no other connection with the trust. See General Explanation at 222, 1st paragraph. Here again, it would seem consistent with die policy of the statute for the regulations to preclude such an unreasonable result.

[3] Similar attribution problems will exist when only pan of the corpus of a trust has been contributed by a United States grantor subject to the provisions of section 679, as in the case of a trust created on or before May 21, 1974, to which there is a subsequent transfer.

(9) Section 1015(c) of the Reform Act added new Code section 1057, which permits an election to treat a transfer of appreciated property to a foreign trust as a sale or exchange of property for an amount equal to the fair market value of the property transferred and to recognized the resulting gain, as a means of avoiding the 35% excise tax under amended Code section 1491. It is doubtful that this section was drafted with any intention of bringing into play the exception for transfers where gain is recognized in play the exception for transfers where gain is recognized in section 679(a)(2)(B), in situations where the does not actually transfer full consideration back to the grantor. The regulations should eliminate any uncertainy as to the interrelationship between sections 1057 and 679.

(10) There are a number of details as to the application of section 679 set forth in the legislative history which do not expressly appear in the statute. If these provisions are to be controlling, they should be embodied in regulations. They include the following:

a. Section 679 applies to an indirect transfer to a foreign trust through the use as a conduit of a domestic or foreign entity in which a United States person has an interest or over which he has sufficient control. General Explanation at 221 and n. 7.

b. Transfer within section 679 may include the guarantee by a United States person of loans to a foreign trust. General Explanation at 221.

c. Transfers to a domestic oust which subsequently becomes a foreign mist (as when an individual trustee moves abroad with the corpus) may be regarded as indirect transfer to a foreign trust. General Explanation at 221 n. 7.

d. The exception in section 679(a)(2)(B) does not apply if gain on the transfer to the mist is reported as an open transaction or as a private annuity. General Explanation at 222.

(11) By section 1013(f)(1) of the Tax Reform Act, Code section 679 is effective for taxable yean ending after December 31, 1975. Presumably, this refers to taxable yean of the grantor, not the trust, and the regulations should so state.

(12) By T.D. 7502, adopted August 18, 1977, 1977-38 LR.B. 42, Temporary Regs. section 404.6048-1 have been issued to require the filing of Form 3520-A, Annual Return of Foreign Trust with U.S. Beneficiaries, in satisfaction of the provisions of Code section 6048(c). However, these regulations are essentially limited to the period covered and the time and place for filing the return, and the instructions to the return form do little more than paraphrase the statute. Permanent regulations should go into greater detail as to how a grantor is to comply with section 6048(c) where he is unable to obtain all the information necessary to complete Form 3520-A from the foreign trustee. In extreme cases of unavailability of any information, it might be permissible to report amounts based on an assumed rate of return on the value of the property originally transferred to the trust Regulations should also provide a method for apportioning trust income to the grantor's taxable year where the trust uses a different accounting period and is unable or unwilling to provide

figures for the grantor’s year. See Temp. Regs. section 404.6048-1(b). It should be borne in mind that the return filing requirements for controlled foreign corporations under Subpart F do not provide a precedent, since sections 679 and 6048(c) apply to foreign Ousts which are neither controlled by nor subject to the direction of the United States grantor. As suggested in paragraph (7) above, it may be desirable for the permanent regulations to provide more detail as to appropriate methods of apportionment where there are transfer to a single trust some of which are and some of which are not subject to section 679. Query whether it is adequate to leave it to the grantor to apportion “in a manner tuft is reasonable in the light of all the circumstances of each case,” as provided in the instructions to Form 3520-A.

(13) The regulations under section 6677(a) should provide guidance, by way of examples or otherwise, as to what will constitute reasonable cause sufficient to avoid the penalty for failure to timely file Form 3520-A, or for filing a form which does not show all the information required.

Exhibit C

January 12, 1990

The Honorable Fred T. Goldberg, Jr.
Commissioner of Internal Revenue
1111 Constitution Avenue, N.W.
Washington. D.C. 20224

Dear Commissioner Goldberg:

Enclosed is a Report by our Committee on Income from Real Property on Section 216(e) of the Internal Revenue Code. The principal draftsmen of this Report were Michael Hirschfeld, Stuart Rosow and Donald Zief.

The Report addresses a number of questions that still need to be clarified in order to achieve Section 216(e)'s intended purpose of providing relief from repeal of the General Utilities doctrine on the conversion from cooperative to condominium ownership of residential apartments used as principal residences. The questions are summarized on page 4 of the Report. The Report recommends that consideration should be given to dealing with these issues by regulation, although the present breadth of regulatory authority to accomplish all that is necessary may not be beyond question. The Report also concludes that certain other legislative changes, similarly listed on page 4 of the Report, may be appropriate to more fully implement the intention of Section 216(e).

Sincerely,

Wm. L. Burke, Chair
New York State Bar Association
New York City, New York

Enclosure

cc(w/encL): Kenneth Klein, Esq.
Associate Chief Counsel (Technical)
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C 20224

Emil D. Muhs, Esq.
Chief, Branch 7
Room 54201R (CC:PESL:BR7)
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C 20224

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

Terrill A. Hyde, Esq.
Acting Deputy Tax Legislative Counsel
(Regulatory Affairs)
Department of the Treasury
4206 Main Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C 20220

Robert J. Leonard, Esq.
Chief Counsel, Staff Director
House Ways and Means Committee
1102 Longworth
Washington, D.C. 20510

Phillip D. Moseley, Esq.
Minority Chief of Staff
House Ways and Means Committee
1106 Longworth
Washington, D.C 20515

H. Patrick Oglesby, Esq.
Chief Tax Counsel, Majority Office
Senate Finance Committee
205 Dirksen
Washington, D.C. 20510

Ed Mihalski, Esq.
Minority Chief of Staff
Senate Finance Committee
203 Hart
Washington D.C 20510

The Honorable Ronald A. Pearlman
Chief of Staff
Joint Committee on Taxation
1015 Longworth
Washington, D.C 20510

Tax Report #642

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

Committee on Income from Real Property[1]

Report on Section 216(e) of the Internal Revenue Code

January 12, 1989

The Technical and Miscellaneous Revenue Act of 1988 (TAMRA) added Section 216(e) to the Internal Revenue Code of 1986 (the “Code”) to alleviate the imposition of a corporate level tax

[1] The principal draftsmen of this report were Michael Hirschfeld, Stuart Rosow and Donald Zief. Helpful comments were also received from William L Burke. John A. Corry, James A. Levitan, Joel E Miller and David Sachs.

on a cooperative housing corporation[2] when its shareholders convert their form of ownership from shares in a cooperative to ownership of condominium units and an allocable portion of the common areas. The Tax Reform Act of 1986 (the “1986 Act”) enacted certain provisions which resulted in the imposition of a corporate level tax on a non-liquidating and liquidating Distributions of appreciated property by corporations.[3] The effect of these provisions on a cooperative housing corporation results in the imposition of tax on such a corporation if the shareholders convert their form of cooperative ownership into

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[2] A cooperative housing corporation is defined in Section 216(b)(1) as a corporation:

"(A) having one and only one class of stock outstanding,

(B) each of the stockholders of which is entitled, solely by reason of his ownership of stock in the corporation, to occupy for welling purposes a house, or an apartment in a building, owned or leased by such corporation,

(C) no stockholder of which is entitled (either conditionally or unconditionally) to receive any distribution not out of earnings and profits of the corporation except on a complete or partial liquidation of the corporation, and

(D) 80 percent or more of the gross income of which for the taxable year in which the taxes and interest described in subsection (a) are paid or incurred is derived from tenant-stockholders." A "tenant-stockholder" is defined in Section 216(b)(2) as "a person who is a stockholder in a cooperative housing corporation, and whose stock is fully paid-up in an amount not less than an amount shown to the satisfaction of the Secretary as bearing a reasonable relationship to the portion of the value of the corporation's equity in the houses or apartment building and the land on which situated which is attributable to the house or apartment which such person is entitled to occupy."

[3] PL 99-514 99th Cong., 2d Sets. (October 22, 1986). The 1986 Act enacted new Code Section 336(a), which provides that gain or loss shall be recognized to a liquidating corporation on the distribution of property in complete liquidation as if such property were sold to the distributee at its fair market value. Code Section 311(b) contains a similar rule for non-liquidating distributions; the 1986 Act removed the remaining exceptions to this rule.

condominium form.[4]

Section 216(e) provides:

Except as provided in regulations, no gain or loss shall be recognized on the distribution by a cooperative housing association[5] of a dwelling unit to a stockholder in such cooperation [sic] if such distribution is in exchange for the stockholder's stock in such corporation, and such exchange qualifies for non-recognition of gain under section 1034(f).[6]

This report expresses our views concerning some of the more important issues which arise under Section 216(e) and to suggest possible approaches Treasury Regulations may take.

GENERAL COMMENTS

Section 216(e) ostensibly protects a cooperative housing corporation from a corporate level tax to the extent the shareholders meet the requirements for gain deferral under Section 1034, However, we believe that several issues must be

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[4] In Private Letter Ruling 8812049 (December 23, 1987), the IRS held that under Section 336(a), a cooperative housing corporation would recognize corporate level gain where it recorded a condominium declaration, adopted a plan of liquidation and distributed its appreciated assets (i.e., apartments plus undivided tenancy in common interests in the common elements) pro rate to its shareholders.

[5] The use of the word “association” is assumed to be a drafting error; it should probably read “corporation.”

[6] See text accompanying notes 15 and 16, infra. Section 1034(a) provides that if a taxpayer sells or otherwise exchanges a principal residence at a gain, and the taxpayer purchases a new principal residence within a period beginning two yean before and ending two years after the sale of the “old residence,” gain on the sale of the “old residence” is recognized only to the extent the sales price of the old residence exceeds the taxpayer's cost of purchasing the new residence (i.e., no gain is recognized if the cost of the new residence exceeds the selling price of the old residence).

resolved before the protection afforded by Section 216(e) complies with the Congressional intent.

We suggest that regulations be issued to address the following issues, although we are concerned that the breadth of the regulatory authority needed to accomplish all that is necessary may not be beyond question. The regulations should:

(1) provide a method for allocating the cooperative apartment corporation's basis in the apartment building to units owned by shareholders who do not meet the requirements for gain deferral under Section 1034, so that the amount of gain to be recognized by the cooperative corporation may be determined;

(2) provide a method for apportioning corporate level tax liability to those exchanging shareholders who did not meet the Section 1034 requirements for deferral of gain and caused the cooperative corporation to recognize income upon conversion;

(3) clarify the coordination between the provisions of Sections 1034 and 216(e);

(4) clarify what is included in the definition of “dwelling unit” and the tax treatment of “other property” distributed in exchange for cooperative housing corporation stock;

(5) address the recapture of tax benefit items;

(6) specify due diligence and record-keeping requirements for cooperative housing corporations converting to condominium ownership; and

(7) clarify that the cross-reference in section 216(e) to section 1034(f) is actually a reference to 1034(a) after application of section 1034(f).

We also suggest that legislation be considered that would offer

(1) a legislative grace period from application of these rules; and

(2) extension of relief to any apartment that is used as a residence by the shareholder or a member of his family.

DISCUSSION

1. EXTENT OF CORPORATE LEVEL GAIN RECOGNITION

Section 216(e) provides for a stockholder-by stockholder test for gain recognition. If the stockholder qualifies under Section 1034 for gain deferral, no corporate level tax is imposed, while if the stockholder does not so qualify, tax is imposed on corporate level gain.

An unresolved question under Section 1034 is the amount of the corporate level gain which must be recognized where the stockholder does not quality for gain deferral. For example, assume that there are ten equal shareholders in a cooperative housing corporation. Nine of the shareholders occupy their cooperative apartment units as a principal residence, while one shareholder uses his apartment unit solely for business purposes and claims annual depreciation deductions with respect thereto. Assume each shareholder paid $100,000 for his unit, and that the basis of the nine “principal residence” shareholders in their units remains at $100,000 while the basis of the “business use” shareholder in his unit, which has been reduced by $25,000 of depreciation deductions, is $75,000. Each unit is worth $150,000 when the shareholders decide to convert their cooperative shares into condominium units. Assume that the corporation's basis in the apartment building at the time of conversion is $800,000. Each “principal residence” shareholder will have a realized gain of $50,000 but will not recognize any gain because of the gain deferral provisions of Section 1034, while the “business use” shareholder will realize and recognize gain of $75 000 The corporation would have a realized gain of $700,000 upon conversion ($1,500,000 aggregate fair market value less $800,000 basis). However, under Section 216(e), the corporation would recognize only a portion of this realized gain, that portion which is attributable to its deemed sale of the “business use” shareholder's unit for the fair market value of $150,000.

The issue raised in the above scenario is determining the amount of the cooperative corporation s basis allocable to this unit. One method is to allocate based on relative values, i.e., each shareholder's unit in this example is worth the same amount - $150,000 – so that 10% of the corporation's basis ($80,000) would be attributable to the unit owned by the “business use” shareholder, and the cooperative corporation would recognize a gain of $70,000 ($150,000 - $80,000). However, this method could result in skewed results where, for example, a 10% shareholder owns a unit which accounts for 15% of the total value of the units, because of differing rates of appreciation for different units over time. Because of this possibility, the simplest method of allocating basis may be to allocate in accordance with share ownership; i.e., a 10% shareholder will have 10% of the building's basis allocated to him, even if his unit accounts for more or less than 10% of the total value. We suggest that forthcoming regulations allocate basis in accordance with share ownership and that forthcoming regulations also provide a method for determining corporate level gain where a shareholder qualifies for partial gain deferral under Section 1034.

2. APPORTIONMENT OF CORPORATE LEVEL TAX

If the cooperative corporation incurs a tax liability because not all tenant-shareholders qualified for gain deferral under Section 1034, the tax presumably will ultimately fall on all condominium unit owners, as transferees of the cooperative corporation. This result causes those shareholder who did qualify for gain deferral under section 1034 (and who did not cause the corporate level tax to be imposed under section 216(e)) to fund a portion of the tax liability caused by the shareholder who did not qualify for Section 1034 treatment.

The fact that Section 216(e) is operative only if Section 1034 deferral treatment is available to a shareholder poses a difficult tax policy issue. Congress may have intended that corporate level gain be recognized if a shareholder does not qualify for gain deferral under the provisions of Section 1034, on the assumption that there exists a satisfactory mechanism for the tax burden to be borne by those shareholders causing gain recognition to the cooperative corporation. On the other hand, it may seem unfair to impose a tax on one shareholder by the will of the majority of other shareholders. (Upon contemplating a purchase of a cooperative apartment, moat the prospective shareholder be informed that the present shareholders have been discussing a conversion to condominium ownership, so that if the prospective shareholder sold a principal residence within two yean before the conversion dale, be will cause the imposition of a corporate level tax and must be prepared to reimburse the other shareholders?)

Tenant-shareholders may adopt a variety of methods for dealing with this problem. However, we believe that a regulatory solution is appropriate, such that tax is imposed on only those shareholders who cause the 216(e) tax on the cooperative corporation. This could be accomplished by permitting an additional assessment on the shareholders who corporate level tax to be imposed, if permissible under state law, and by providing that such additional assessment will not result in the disqualification of the corporation as a cooperative housing corporation under Section 216.

3. COORDINATION OF SECTION 216(e) WITH SECTION 1034

Section 216(e) affords protection against income recognition at the corporate level if the distribution of the dwelling unit to the stockholder in exchange for his stock “qualifies for non-recognition of gain under Section 1034(f).”[7] Section 1034(c)(1) provides that for 1034 purposes, “An exchange by the taxpayer of his residence for other property shall be treated as a sale of such residence, and the acquisition of a residence on the exchange of property shall be treated as a purchase of such residence.” Consequently, the relief afforded by Section 216(e) is available only if the deemed purchase of the

[7] See text accompanying note 6, supra. See also text accompanying notes 15 and 16, infra for our suggestion that the reference to Section 1034(f) be clarified so that it is clear that it means that non-recognition of gain occurs under Section 1034(a) after application of Section 1034(f).

condominium unit and the deemed sale of the cooperative unit are matched against each other under Section 1034. As explained in more detail below, the deemed purchase and sale upon conversion will be matched against each other (and thus permit non-recognition of corporate level gain) only if all of the following are true: (i) each shareholder occupies his apartment unit as his principal residence (ii) the shareholder held his cooperative apartment unit for at least two years prior to the conversion, and (iii) the shareholder does not purchase a new principal residence for at least two years after the conversion.

A. MULTIPLE PURCHASES WITHIN TWO YEAR PERIOD.

Section 1034(c)(4) provides that where a taxpayer purchases more than one principal residence within two yean after the sale of his “old” principal residence, only the last purchase is matched against the sale to determine the gain deferral under section 1034. Thus, assume Taxpayer A sells his old residence for $300,000, with a basis of $100,000, and within 6 months purchases a coop apartment for $300,000. A has a realized gain of $200,000. If this is the only purchase during the two-year period, then under the provisions of Section 1034(a),[8] the $200,000 gain is deferred and the basis of the coop will be $100,000 ($300,000 purchase price - $200,000 gain deferred). Assume, however, that nine months later, the co-op is converted into a condominium when the fair market value of the co-op has fallen to $250,000. Because the acquisition of a residence on the exchange of

[8] See footnote 6, supra.

property is treated as a purchase under section 1034(c)(1), the conversion causes this purchase to be matched against the original sale instead of the deemed conversion tale of the cooperative apartment. Because this purchase is deemed to be for $250,000 and the original sale was for $300 000, $50,000 of the $200,000 realized gain on the original sale must be recognized by the shareholder. Also, there is a nondeductible Ion on the deemed sale under Section 262 ($250,000 selling price less $300,000 purchase price).

Accordingly, because a conversion of a cooperative housing corporation to condominium ownership and the deemed distribution of the unit to the former co-op shareholder in exchange for his co-op shares is viewed as a purchase and sale transaction, the pin on such a deemed sale by the corporation is not protected by section 1034 if the conversion occurs within two yean of the shareholder's original sale. Because Section 216(e) does not apply if Section 1034 does not protect a shareholder from gain recognition, the cooperative corporation is subject to tax as well as the shareholder in this instance.

It is not clear whether Congress intended this result It may be that Congress intended Section 216(e) to operate whenever a shareholder met the principal residence requirement of Section 1034, regardless of whether the shareholder met the remaining requirements of Section 1034 for non-recognition of gain. One way to eliminate the double tax in die above example would be by providing that solely for applying Section 1034 for 216(e) purposes, the value (or purchase price) of the condominium unit on conversion will be deemed to be equal to the price paid for the shares in the cooperative housing corporation. This rule would allow Section 1034(c)(4) to operate and tax the shareholder, but would treat the exchange as qualifying for non-recognition under Section 1034 for 216(e) purposes and protect the cooperative corporation from recognizing gain due to a deemed sale and purchase when the market value of the cooperative shares has not risen above their cost while the actual living space has not been sold or exchanged.

A simpler approach would be to assume non-recognition for the shareholder under Section 1034 for 216(e) purposes as long as the shareholder met the principal residence requirement under Section 1034 for both the original sale and the cooperative unit This approach would permit Section 1034 to operate normally but would not trigger corporate level tax under Section 216(e) if the shareholder was dealing only in principal residences.[9]

There should be room to implement either of these approaches through regulations, but the authority may not be beyond question.

B. MULTIPLE SALES.

A more pervasive problem for a taxpayer engaged in a conversion transaction arises if the taxpayer has two or more sales during a two-year period. Section 1034(d)(1) does not

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[9] The Conference Agreement indicates that anticipated regulations to be promulgated under the regulatory authority granted in Section 216(e) are to be restrictive; i.e., such regulations are to assure that (i) the intended relief is provided only in cases where the house or apartment is in fact used by the taxpayer as his principal residence both before and after the distribution, and (ii) there is a full recapture of tax benefits (if any) that may have been claimed at the corporate level to the extent the same benefits could not have been claimed by the shareholder if he had owned the house or apartment directly and used it as his principal residence. Conf. Rep., No. 100-1104, 100th Cong., 2d Sess. 241 (1988). It is arguably relevant, however, that Section 216(e) addresses only Section 1034(f), leaving the usual breadth of authority for interpretation of the scope of Section 1034(a).

permit deferral treatment for gain on the sale of a principal residence if the taxpayer sold other property used as a principal residence within two yean before such sale and any gain was deferred under section 1034. To illustrate the working of this rule in the conversion scenario, assume in the above example that instead of the market value of the coop apartment declining to $250,000, it increased to $340,000. Under the rule of Section 1034(c)(4) described above, this conversion/purchase will be matched against the original sale at $300,000, and because the deemed purchase price under the conversion is greater than the original selling price, the gain on the original sale should be deferred, thus avoiding the problem of Section 1034(c)(4) noted above.

However, because the taxpayer sold his original home less than two yean before the deemed sale of his co-op shoes upon conversion, and gain on such sale was deferred under Section 1034(a), the rule of Section 1034(d)(1) would operate to deny deferral treatment on the conversion sale even if a principal residence is subsequently purchased. Thus, the realized gain of $40,000 on the conversion ($340,000 deemed selling price of co-op less $300,000 basis in co-op) must be recognized. Further, because 1034(a) does not apply to the conversion. Section 216(e) would also not protect the cooperative housing corporation from the recognition of an entity level tax.

Thus, because a conversion of a cooperative housing corporation to condominium ownership and the distribution of a condominium unit to a coop shareholder in exchange for his co-op shares is viewed as a second sale within two yean of the first sale, the gain on such a deemed sale is not protected by Section 1034. Once again, the literal language of Sections 1034(d)(1) and

216(e) require taxation of the corporation if the shareholder is taxed on the conversion.

The impact of Section 1034(d)(1) on Section 216(e) is even more dramatic when there has been no change in value in the cooperative unit Assume in the above example that the taxpayer sold his old residence for $300,000 and purchased a co-op apartment for $300,000. The apartment was worth $300,000 upon conversion which occurred fifteen months after the sale of the taxpayer's old residence. Under Section 1034(c)(4), the conversion purchase of the condominium is matched against the original sale and the taxpayer will recognize no gain. Section 1034 does not apply to the conversion sale of the coop apartment; however the apartment was sold for its adjust basis of $300,000 and there is no gain realized. For Section 216(e) purposes, however, the exchange of the condominium unit for the shareholder’s stock did not qualify “for non-recognition of gain under Section 1034(f)” (even though there was no gain to be afforded non-recognition) because the conversion purchase of the condominium was matched against the original sale of the old residence under Section 1034(c)(4) and not against the conversion sale of the shareholder's stock. Therefore, even though the shareholder has no gain, the coop's association would be subject to tax on part of any gain it realized on the liquidation.

We suggest that regulatory authority be exercised so as to afford protection to the cooperative corporation under Section 216(e), but not to disturb the present operation of Section 1034 with respect to taxation of the shareholder. However, as noted above, it may not be beyond question whether the grant of regulatory authority is broad enough to permit the Treasury Department to cure this through regulations.

4. DEFINITION OF “DWELLING UNIT”

Section 216(e) protects against recognition of corporate level gain upon distribution of a “dwelling unit” to a stockholder. We suggest that regulations clarify what is included in this definition. A typical cooperative-to-condominium conversion may take the following form: (i) the cooperative corporation records a declaration of condominium subjecting the apartment building and land on which it is situate to the stale's condominium act, each apartment is designated a separate condominium unit with an appurtenant proportionate undivided tenancy-in-common interest in the common elements and an association of unit-holders is created; (ii) each cooperative shareholder exchanges his shares in the corporation for a deed to his condominium unit (which includes such unit's appurtenant common interest); (iii) the corporation transfers all other property, such as grounds-keeping equipment and lobby furniture and cash reserves to the unit-holders' association; and (iv) the corporation is dissolved.[10] Sometimes the dissolving cooperative corporation may transfer investment-type assets, such as stocks or bonds, directly to the unit-holders instead of distributing such assets to the unit-holders' association.

A condominium owner’s undivided tenancy-in-common interest in common elements and areas may include an interest in commercial space and recreational facilities. Regulations should clarify whether, and to what extent, such items, as well as a unit-holder’s interest in cash reserves and investment assets formerly held by the cooperative corporation, are included in the

[10] See Miller. “Congress Grants Coops Limited and Uncertain Relief from General Utilities Repeal,” 5 Tax Mgmt. Real Est. J. (January 4, 1989).

term “dwelling unit,” and therefore excluded in computing corporate level gain.[11]

It may be appropriate to include recreational facilities, but not commercial space, under the “dwelling unit” umbrella; i.e., a dwelling unit can conceivably include a right to use a swimming pool but not to income from commercial sources. By excluding commercial space and other property from the definition of “dwelling unit,” both the shareholder who otherwise meets the requirements of section 1034 and the cooperative corporation incur a taxable event. For example, assume a tenant-stockholder's basis in his unit is $100,000. The tenant/stockholder receives a condominium unit (including a proportionate interest in appurtenant common areas) plus an undivided interest in cash reserves, and other tangible personal property, the sum total of which equals $150,000. The sum of the cash and personal property equals $25,000. Upon conversion, the tenant-stockholder would be viewed as having sold his unit for $150,000 but reinvesting $125,000 so that he would recognize a gain of $25,000 under Section 1034. This would also produce a corporate level gain, which is not protected by Section 216(e).

An alternative to excluding items from the definition of “dwelling unit” is to treat all property distributed as coming under the “dwelling unit” umbrella, but with a required basis allocation to all assets distributed, in order to ensure gain recognition on subsequent disposition of these assets. Finally, a

[11] Under Section 1034, property used by the taxpayer as his principal residence does not include personal property such as furniture, which is not a fixture under local law. Thus, gain attributable to the sale of such assets must be recognized. Treat Reg. section 1.10341(c)(3)(i).

possible “safe harbor” could be prescribed by regulations to the effect that “other property” would be included in the term “dwelling unit” as long as the value of such property did not exceed the lesser of 10% or some nominal amount of the total value of property distributed.

A further issue concerns the treatment of the property owned by the condominium unit-holders' association. A strong argument for inclusion in the term “dwelling unit” is that a unit-holder's interest in such property can generally not be separately transferred by individual action, yet a valid argument against such inclusion is that there is no direct limit on the type or amount of property such an association may own.[12] In this latter case, the transfer of property by the cooperative housing corporation to the unit-owners' association could generate a corporate level tax on the cooperative, as there is no section 216(e) protection. Regulations should address these concerns.

5. RECAPTURE OF TAX BENEFITS

As noted earlier, regulations are to insure that there is a full recapture of any tax benefits claimed at the corporate level to the extent the same benefits could not have been claimed by the shareholder if he had owned the house or apartment directly and used it as his principal residence.[13] For example, depreciation claimed by the cooperative corporation which shelters commercial or investment income earned by the cooperative should probably be recaptured, while depreciation which shelters rental income paid by the shareholders should probably not be recaptured. However, regulations should not go so

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[12] Id.

[13] See footnote 9, supra.

far as to deny the Section 216(e) relief in non-abusive situations. An anti-abuse provision may also be necessary so as to deny the benefits of Section 216(e) in certain cases.[14]

6. COOPERATIVE CORPORATION DUE DILIGENCE

Because under Section 216(e) the corporate level tax is dependent upon whether exchanging shareholders qualify for the gain deferral provisions at Section 1034, it is necessary for the cooperative corporation to ascertain the status of the exchanging shareholders. We suggest that the regulations specify exactly how this is to be accomplished and also provide an exemption from the imposition of any penalty on the cooperative corporation for an inadvertent failure to carefully determine the status of exchanging shareholders.

One alternative may be to require an affidavit from a converting shareholder, to the effect that the apartment unit is his principal residence, there have been no other purchases of principal residences in the immediately preceding two-year period or if there have, the selling price of the first such sale during this two-year period is less than the deemed purchase price of the condominium unit for which he is exchanging cooperative

[14] One such situation may be where a purchaser is desirous of acquiring the cooperative housing apartment building and tenant stockholders first convert to condominium ownership to avoid double-level taxation on the sale and subsequent liquidation of the corporation. A further issue concerns whether the cooperative corporation must recognize a gain upon liquidating or non-liquidating distributions if the mortgage on the building is in excess of the building's basis, even though all shareholders may qualify for deferral treatment under Section 1034. If the fair market value of the cooperative apartment building is equal to or less than the basis of the building and the mortgage liability is in excess of the basis. Sections 336(b) and 311(b) operate to cause the cooperative corporation to recognize gain upon condominium conversion if the distributee shareholders assume or take subject to the mortgage on the cooperative building. As a practical matter, the mortgage in excess of basis issue may not be a serious concern because many states do not permit blanket mortgages on condominium units. See, e.g., N.Y. Real Property Law section 339-r.

shares, and during the immediately preceding two year period, there have been no other sales of principal residences pursuant to which gain was deferred under the provisions of Section 1034.

Another alternative (or perhaps an additional requirement) is for the cooperative corporation to require federal and/or state income tax returns from the converting shareholders for the immediately preceding two-year period in order to ascertain purchases and sales of principal residences. (Of course, there is no guarantee that the results of a federal or state audit during this period will not change what a shareholder thought was a non-Section 1034 transaction into a transaction covered by Section 1034 and triggering the corporate level tax because of the issues discussed above.) Many cooperative corporations already obtain this information for other purposes; all cooperatives now may be required to obtain it.

In effect, the passage of section 216(e), intended as a relief provision, may now require cooperative corporations to retain the same records as a shareholder must to substantiate that he qualifies for the gain deferral provision under Section 1034. We believe regulations should address how onerous this record-keeping requirement will be. Out of respect for the privacy of tax returns generally, we believe that the regulations should permit the less onerous alternative of permitting the cooperative corporation to rely on an affidavit so long as it does not know the affidavit is inaccurate.

7. CROSS-REFERENCE TO SECTION 1034(f)

Section 216(e) permits non-recognition of gain to the cooperative corporation if the exchange of the dwelling unit distributed by the cooperative corporation to the stockholder in exchange for his stock would qualify for non-recognition of gain under SECTION 1034(f) (emphasis added). However, Section 1034(f) merely provides that references to the taxpayer's “residence” are to be deemed to be references to cooperative corporation shares be owns.[15] Section 1034(c)(1) is the only provision which deals with exchanges and Section 1034(a) provides for non-recognition of gain.[16] We suggest that the reference to Section 1034(f) in Section 216(e) be modified so that it is clear that non-recognition of gain occurs under Section 1034(a) after application of section 1034(f).

8. TRANSITION RELIEF

While the repeal of the General Utilities doctrine by the 1986 Act reflected a conscious policy decision on the part of Congress to tax corporations upon their liquidation, we question whether the specific impact of that repeal on coop to condominium conversions was considered at that time. In view of the lack of change of beneficial ownership accompanying a coop to condominium conversion and the perceived trap for the unwary that the legislation presented in this specialized area immediately after enactment of the 1986 Act, we would recommend legislative

[15] In PLR 8812049, supra note 4, taxpayer cited section 1034(0 in support of its argument that section 336(a) should not be extended to situations involving mere changes in the form of ownership of property where the scheme of management and shared ownership remains the same as before this conversion.

[16] See notes 6 and 8, supra.

consideration of a grace period under which a coop could be converted to condominium status without incurring any corporate level tax (other than for recapture items). Such legislative pace period could be made retroactive only if there is a perception that prospective application would allow for transactions that may be viewed as abusive.

9. EXTENSION OF COVERAGE BASED ON PERSONAL USE

Section 216(e) only offers relief from corporate level tax where the shareholder occupies his or her apartment as a "principal residence." Similarly, Section 1034 only offers relief to a shareholder who occupies the apartment as a principal residence although Section 1031 may offer relief to those shareholders who use their apartments in a trade or business (e.g., rental purposes) or hold for investment There is no relief afforded at both the corporate level and the shareholder level for those individuals who use the apartment as a residence but not a principal residence.

We would recommend consideration of a legislative amendment to both Section 216(e) and Section 1034 so as to allow solely for the purposes of a coop to condominium conversion, relief from corporate and shareholder level tax to an individual shareholder who owns an apartment that is used by the shareholder or a member of his family as a residence. We believe this appropriate in that most coop owners own coop shares merely as a method of owning an apartment and that this suggested legislative change would eliminate an unwarranted taxable event where there is solely personal use of the apartment with the underlying beneficial ownership not changing in any manner as a consequence of the conversion.