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December 11, 2002

The Honorable Pamela F. Olson
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Robert E. Wenzel
Acting Commissioner
Internal Revenue Service
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Ladies and Gentlemen:

I am writing in response to TD 9017, in which the Internal Revenue Service and Treasury Department requested comments on particular types of transactions that should be exempted from disclosure or excluded from individual categories of "reportable transactions" under Treas. Reg. § 1.6011-4T, relating to tax shelter disclosure. This letter summarizes comments by individual members of the New York State Bar Association Tax Section. These suggestions have not been considered or approved by the Tax Section's Executive Committee. The Tax Section intends to submit in the near future a full report on the temporary and proposed regulations under Treas. Reg. §§ 1.6011-4T and 301.6112-1T. This letter is submitted in advance of our report based on our understanding that the Internal Revenue Service and Treasury Department may publish guidance regarding exceptions to the definition of "reportable transactions" prior to finalizing the proposed regulations.

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A. Confidential Transactions

1. A confidentiality agreement entered into between principals (and binding on, or entered into by, their employees and agents) in connection with a proposed merger or acquisition transaction involving assets constituting an active trade or business should not cause the transaction to be a "reportable transaction" so long as the agreement is amended, no later than the earlier of (i) the public announcement of the transaction, or (ii) 10 days following the time of entry into a binding agreement relating to implementation of the transaction, to permit disclosure of the Federal income tax aspects of the transaction and those structural elements relevant thereto.[1]

Explanation: M&A transactions are generally negotiated under conditions of confidentiality. In the vast majority of cases, this has nothing to do with "confidential" tax schemes. Companies are highly sensitive to the disclosure of the mere existence of discussions, disclosure of which could be disruptive in many respects, including effects on employee morale, and are also insistent on guarding confidentiality of business information. Requiring a tax non-confidentiality "release" at the beginning of such a transaction would likely lead to substantial efforts to craft a release in such a manner that legitimate business needs of confidentiality are fully protected. This could be particularly difficult since it is often unclear at preliminary phases of discussion what the form of the transaction would be.

Any "safe harbor" regarding M&A confidentiality "tax releases" should also permit appropriate safeguarding of proprietary corporate information (including confidential tax return information), and only relate to the "tax idea" of the structure (which will often be entirely banal, such as a tax-free stock-for-stock merger). It would be helpful if the IRS developed a form of approved "release" language that addresses this concern. Practices developed in connection with deletion of identifying information when private letter rulings are released should prove helpful. This is a topic on which the IRS may wish to solicit further comment.

2. A tax opinion or memorandum rendered to a client that does not permit the client to provide it to another (except as required by law, including the listing and disclosure regulations) or to quote it to another as the opinion

[1] References in Treas. Reg. § 1.6011-4T(b)(3) to "tax aspects" or "tax consequences" should be modified to insert "Federal income" before the word "tax." Similar modification should be made in subsection. (b)(4), relating to contractual protections.

of the lawyer or firm providing the opinion should not be considered as imposing a condition of confidentiality (or preclude reliance on the presumption of non-confidentiality under § 1.6011-4T(b)(3)(iv)) so long as the opinion permits full disclosure of the reasoning of the opinion and any tax structure to which it relates.

Explanation. This issue comes up in circumstances where a law firm wants to protect against unwarranted reliance on its opinion by third parties. For instance, in a securities offering or proxy solicitation the tax opinion provided to investors or shareholders may be that of an in-house lawyer who requests a "backup opinion" from outside counsel. Alternatively, there may be no lawyer or firm mentioned in connection with the tax disclosure, but outside counsel may be asked to provide an opinion to the client as well as draft the disclosure. In such a context, outside counsel may not want its name invoked so as to avoid inappropriate claims of reliance by parties other than the recipient of the opinion.

3. The "securities law exception" to the confidentiality filter should include not only restrictions reasonably necessary to comply with federal and state securities laws but also restrictions reasonably necessary to comply with securities laws of a foreign jurisdiction.

B. Transactions with Contractual Protections

1. Neither an obligation to make "gross-up" payments in the event withholding tax is imposed (or the rate of withholding is increased) nor the ability to terminate a transaction if withholding is imposed (or the rate of withholding is increased) should cause a transaction to be "reportable."

Explanation. Gross-up and/or termination provisions in the event withholding tax is imposed are standard not only in loan and credit documentation (which are addressed in the regulations) but also in, among others, documentation based on forms developed by the International Swaps and Derivatives Association, Inc., and securities lending documentation. There are massive numbers of such transactions and requiring their disclosure would serve no useful purpose.

2. There should an exception relating to customary contractual protections relating to the dividends-received deduction, *i.e.*, gross-ups in the event of insufficiency of earnings and profits or gross-ups in the event of a change in the rate of the dividends-received deduction. A tax call in the event such gross-ups are imposed should also be included in the exception.

3. There should be an exception for an undertaking by the promoter of an "investment partnership" (as defined in section 731(c)(3)(C)) to investors (including undertakings coupled with specific contractual remedies in the event of breach of such an undertaking) to avoid activities or investments that would give rise to "income effectively connected with the conduct of a U.S. trade or business" (within the meaning of section 861(c))or "unrelated business taxable income" (within the meaning of section 512).

4. There should be an exception for customary tax-related representations, warranties and indemnities provided by a principal to a transaction, or a shareholder of a principal, in connection with mergers, acquisitions, or spinoffs of entities engaged in, or transfers of assets that constitute, an active trade or business.

Explanation. Such representations, warranties and indemnities are commonplace, and requiring disclosure and list-keeping with respect to such transactions could be enormously burdensome and unproductive. The current exception for principals is inadequate in two respects. First, the requirement that the principal not be engaged in promoting the transaction is too vague, as most principals engage in behavior that arguably constitutes "promoting" the transaction. Second, it is commonplace to require major shareholders of principals to give representations, warranties and indemnities in connection with such transactions.

To the extent that the exception is viewed as potentially overbroad, it could be limited to transactions as to which the active trade or business has been conducted for some period of time (*e.g.*, more than one year) prior to the transaction in which representations, warranties and indemnities are offered. It would be helpful to clarify that "acquisitions" include acquisitions of stock or securities for consideration (cash or assets relating to the pre-existing business of the issuer of the stock or securities) the amount or value of which constitute more than a specified percentage (*e.g.,* five percent) of the equity value of the issuer following the issuance of the stock or securities. While the imposition of a requirement (in order that the exception be available) that the provider of the representations, warranties and indemnities not provide substantial tax advice could be considered, this requirement should not preclude statements of tax consequences in publicly filed documents such as proxy solicitations, tender offers, etc.

C. Loss Transactions

1. An exception should be considered, as mentioned in the preamble to the regulations, relating to losses resulting from a sale of securities (including stock) on an established securities market, provided that the taxpayer's basis used in computing the loss is equal to the amount of cash paid by the taxpayer for the securities. Points for consideration in connection with such an exception include:

a. Presumably the intended reference in defining an established securities market is § 1.7704-1(b).[2]

b. It might be appropriate to limit the exception so that it does not apply where, within the period beginning 30 days prior to such sale and ending 30 days thereafter, the taxpayer has taken a position (within the meaning of section 1092(d)(2)) with respect to the same or substantially identical securities (within the meaning of section 1091), so that disclosure of wash sale strategies is required. In this regard, it might be appropriate, in the case of losses claimed with respect to sales of stock, to require disclosure where the taxpayer has taken a position within the 61-day period with respect to any combination of securities that would be viewed (*vis-à-vis* the stock as to which a loss was claimed) as a position with respect to "substantially similar or related property" within the meaning of § 1.246-5.

c. Consideration should be given to broadening the proposed exception to include deductions under section 165(g) for worthless securities that were personal property (within the meaning of section 1092) at the time they were acquired. This category would be subject to the requirement that the taxpayer's basis in the worthless security equal the amount of cash paid by the taxpayer for the security.

d. In addition, an exception should be considered for losses incurred in connection with the satisfaction or extinguishment, pursuant to a bankruptcy plan of reorganization or liquidation, of claims against a person under the jurisdiction of a court in a title 11 or similar case, provided that such claims either (i) claims described in section 382(l)(5)(E)(ii) (*e.g.*, trade

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[2] Note that this reference would appear to exclude losses incurred in connection with the sale for cash to a dealer of a readily quotable debt instrument (*cf.* § 1.1273-2(f)(5)). Consideration might be given to broadening the reference to encompass such transactions.

creditors, which should not be required to have purchased their claims for cash), or (ii) claims as to which the holder's basis equals the amount of cash paid for such claim. Consideration might also be given to broadening this exception to include losses recognized in connection with the sale of such claims (or shares of the debtor) for cash, whether or not on an established securities market.

e. Consideration should be given to including in the exception losses claimed by writers (as well as buyers) of exchange-traded options on securities, provided that the loss claimed equaled the difference between the cash received by or credited to the account of the taxpayer in connection with writing the option and the cost of settling or closing out the option on the exchange.

f. Consideration should be given to including in the exception losses incurred by short-sellers of securities traded on an established securities market provided that the loss claimed equals the difference between the proceeds of the short sale (which could be limited to short sales executed on the established securities market) and the basis of the securities used to close out the short sale (which should be equal to the amount of cash paid by the taxpayer to acquire the securities used to close out the short sale).

2. The exception mentioned in the preamble to the regulations, relating to losses claimed under section 475(a) and 1296(a) seems appropriate. Consideration should be given to extending the exception to other losses recognized under a mark-to-market method of accounting (*e.g.*, section 475(f), section 1256).

3. The inclusion within the definition of "reportable transaction" of transactions "reasonably expected" to result in losses under section 165 should be clarified and narrowed.

Explanation. In view of the fact that losses that are actually claimed are generally subject to disclosure, there should be an exception for entry into transactions where losses may be probabilistically anticipated but are not sought. Examples include:

a. Investment vehicles organized to make speculative investments (*e.g.*, merchant banking and venture capital funds), which will predictably incur losses as well as gains, but which generally are not designed to produce (or marketed as producing) tax losses. The key point is that

organization of such a fund (including soliciting of investors) should not be viewed as a reportable transaction. Crafting an exception based on subjective intent may be problematic (though it should be noted, in this regard, that the category of "reasonably expected" losses is itself somewhat vague and could be understood to have a subjective element to it). A possible wording of the exception would be: "Organization of an investment partnership (within the meaning of section 731, or an entity that would be an investment partnership but for the fact that it is a corporation or disregarded entity) shall not be a reportable transaction provided that (i) all interests in such partnership or other entity (other than interests issued for services) are acquired for cash (or in exchange for a commitment to invest cash upon demand), (ii) substantially all of the assets of such partnership or other entity are expected to consist of stock or securities purchased with cash contributed by investors or borrowed by such entity[3], and (iii) such entity is not marketed as producing tax losses or deductions." With respect to the third point, it should be clarified that standard disclosure that investments will be speculative and that losses may be incurred does not constitute marketing of the entity as producing tax losses or deductions.

b. While the organization of "hedge funds" that are expected to take offsetting positions introduces issues not present in the case of "plain vanilla" investment partnerships, it is nonetheless desirable to provide an exception that includes such vehicles. In crafting such an exception, the language suggested in the preceding paragraph (excluding the language in clause (ii)) can serve as a beginning point. If there is concern that exclusion of clause (ii) produces too broad an exception, consideration could be given to requirements based on one or more of the following characteristics of hedge funds that are not organized for tax avoidance purposes: First, the manager of the fund is typically compensated by reference to the net asset value of the fund (in the form of a management fee for assets under management and an incentive fee for economic returns), or in a comparable manner that reflects economic return without regard to tax results. Second, the same investment strategy is typically marketed to taxable, tax-exempt and foreign investors (typically by providing a foreign corporate vehicle for tax-exempt and foreign investors and a partnership vehicle for taxable U.S.

[3] Borrowing by investment funds is often precluded by the organizational documents because of the participation of tax-exempt investors that are unwilling to incur debt-financed income subject to tax pursuant to section 514. There should, however, be no reason for concern if the fund does in fact borrow to fund investments.

investors). The investments by tax-exempt and foreign investors in a vehicle employing the same investment strategy is evidence that the funds are not organized to promote non-economic tax avoidance strategies. Of course, it is possible that a vehicle organized for bona fide investment purposes would at some point engage in a "loss generator" transaction. But it is the entry into *that* transaction, not the organization of the vehicle, that should be reportable (unless the vehicle is marketed to investors as producing tax losses).

c. It is also desirable to provide an exception for the organization of typical real estate investment funds. Such funds are similar to merchant banking funds (see paragraph a), except that real estate investment funds typically use borrowed money as well as cash contributed by investors to buy investments, whereas in the case of merchant banking funds leverage more typically incurs at the level of the investee companies. The distinction arises from the fact that both types of funds are typically marketed to tax-exempt investors, among others, and leverage at the fund level would cause "unrelated business taxable income" problems for tax-exempt investors in the case of merchant banking funds, whereas leverage does not cause such a problem in the case of real estate funds provided that the "fractions rule" of section 514(c)(9) is observed.

d. Rather than provide a list of vehicles such as those described in the three preceding paragraphs, the organization of which will not be a reportable transaction, it might be preferable to provide a more general exception for the organization of investment vehicles (i) interests in which are acquired in exchange for cash (or in consideration of a commitment to invest cash) and (ii) which are not marketed as producing tax losses or deductions, and (iii) as to which, at the time of marketing, there is no reasonable expectation that an investor will recognize material tax losses or deductions except in connection with economic losses or expenses incurred by the vehicle and borne by the investor.

4. An exception should be considered for losses properly reported and accounted for by a "C" corporate or individual taxpayer as losses on hedging transactions, within the meaning of § 1.1221-2, that were entered into by the taxpayer claiming the loss (or by a disregarded entity wholly owned by such taxpayer). Hedging losses incurred by a partnership, S corporation or other flow-through vehicle would not be covered by this exception. While it is possible that an exception could be crafted for the latter cases, that would require further consideration in order to prevent potential abuse.

Explanation. By definition, hedging losses are entered into in the normal course of a trade or business, and § 1.446-4 requires that the accounting for hedging losses must clearly reflect income. Large corporations may enter into large numbers of hedging transactions on a daily basis, and requiring special record-keeping or disclosure with respect to losses on hedging activity beyond what is already required could be extremely onerous and unproductive.

D. Book-Tax Differences

In addition to (or by way of expansion of) exceptions already provided in the regulations, exceptions should be considered for book-tax differences arising from:

1. Dispositions of assets with different tax and book basis. Such basis differences could arise, for instance, from (i) GAAP purchase accounting for a transaction treated as a stock acquisition or a tax-free reorganization for tax purposes, (ii) different methods, lives or conventions for depreciation, amortization or depletion,[4] or (iii) fresh-start accounting for a debtor that undergoes a bankruptcy reorganization.

2. Dispositions of subsidiaries that are treated as stock sales or tax-free reorganizations for tax purposes.

3. Positions subject to hedge accounting for tax but not book purposes, or visa versa, and positions subject to hedge accounting for both book and tax purposes to the extent that the difference is attributable to differences between GAAP and tax hedge accounting.

4. Positions that are marked-to-market for book but not tax purposes, or visa versa.

5. Partnership remedial allocations, which create phantom tax income and deductions.

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[4] While the regulations contain an exception for such differences in depreciation, amortization, or depletion, they do not provide a corresponding exception where the assets in question are subsequently disposed of.

6. Contingent debt, as to which the accruals and positive or negative adjustments prescribed under § 1.1275-4 will generally differ from GAAP treatment.

7. Other transactions with imputed interest for income tax purposes, such as loans under section 7872 and debt instruments with a less-than-AFR interest rate under section 1274.

8. Differences between consolidated reporting for book purposes and the consolidated return for tax purposes.

9. Differences between GAAP and tax accounting for debt-for-debt exchanges.

10. Deemed reissuances of debt securities for tax purposes, such as those arising under section 108(e)(4) or on account of "material modifications" within the meaning of § 1.1001-3. While the cancellation of indebtedness produced for tax purposes by such transactions is already excepted, the exception as currently phrased does not cover the subsequent accrual on OID on the reissued debt instrument.

11. Section 1031 exchanges that produce book gain (*e.g.*, where an unrelated third party acquires the relinquished property for cash from a qualified intermediary in a multi-party exchange).

12. Receipt of proceeds of a life insurance policy that are not taxable but constitute income for book purposes.

13. Book recognition of income or loss in certain derivative transactions relating to the issuers stock (*e.g.,* cash-settled options on the issuer's stock) that do not give rise to tax gain or loss pursuant to section 1032.

E. Transactions Involving a Brief Asset Holding Period

1. An exception should be considered for foreign tax credits that a securities dealer is permitted to claim under section 901(k)(4).

2. Consideration should be given to providing an exception for credits relating to foreign withholding on interest notwithstanding that the holder of the debt instrument has engaged in hedging transactions (within the meaning of § 1.1221-2) with respect to such instrument. This exception

would mean that banks and other entities that hold debt instruments as "ordinary property" would not have to report their hedging activity (notwithstanding the fact that the hedging activity might toll holding period for purposes of section 246 if the instrument were equity). Requiring such reporting does not serve any clear purpose, since there is no general tax rule disallowing the credit on account of such hedging.

F. General Exemption

1. An exemption for disclosure under the new disclosure regime (effective after January 1, 2003) should be preserved for a transaction as to which the taxpayer has received a ruling from the IRS that reporting was not required under the prior disclosure regime. While the fact that the new rules only apply to transactions entered into after January 1, 2003 makes this a narrow category, there may be aspects of a transaction as to which a ruling has previously been obtained that might be viewed as "entered into" after January 1, 2003.

Please feel free to contact the undersigned if you wish to discuss any of the proposed exemptions or any other exemptions you are considering.

Respectfully submitted,

Samuel J. Dimon
Chair

cc: Jeffrey H. Paravano
Eric Solomon
Helen Hubbard
The Honorable B. John Williams, Jr.
Gary B. Wilcox
Tara P. Volungis
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