



New York State Bar Association

One Elk Street, Albany, New York 12207 • 518/463-3200 • <http://www.nysba.org>

TAX SECTION

2006-2007 Executive Committee

KIMBERLY S. BLANCHARD

Chair
Weil Gotshal & Manges LLP
767 Fifth Avenue
22nd Floor
New York, NY 10153
212/310-8799

PATRICK C. GALLAGHER

First Vice-Chair
212/446-4998

DAVID S. MILLER

Second Vice-Chair
212/504-6318

CHARLES MORGAN

Secretary
212/735-2470

COMMITTEE CHAIRS:

Bankruptcy and Operating Losses

Stuart J. Goldring
Deborah L. Paul

Compliance, Practice & Procedure

Robert Cassanos
Bryan C. Skarlatos

Consolidated Returns

Lawrence M. Garrett
Jonathan Kushner

Corporations

Kathleen L. Ferrell
Gordon Wamke

Employee Benefits

Andrew L. Oringer
Max J. Schwartz

Estates and Trusts

Carlyn S. McCaffrey
Jeffrey N. Schwartz

Financial Instruments

Michael S. Farber
Erika W. Nijenhuis

Financial Intermediaries

Dickson G. Brown
Yaron Z. Reich

"Inbound" U.S. Activities of Foreign

Taxpayers

David R. Hardy
David R. Sicular

Individuals

Janet B. Korins
Sherry S. Kraus

Multistate Tax Issues

Robert E. Brown
Paul R. Comeau

New York City Taxes

Robert J. Levinsohn
Irwin M. Slomka

New York State Franchise and

Income Taxes

Maria T. Jones
Arthur R. Rosen

"Outbound" Foreign Activities of

U.S. Taxpayers

Peter H. Blessing
Jodi J. Schwartz

Partnerships

Joel Scharfstein
David H. Schnabel

Pass-Through Entities

Andrew W. Needham
Marc L. Silberberg

Real Property

William B. Brannan
Elliot Piser

Reorganizations

Karen Gilbreath Sowell
Linda Z. Swartz

Securitized and Structured

Finance

Jiyeon Lee-Lim
W. Kirk Wallace

Tax Accounting

Jeffrey Hochberg
Stephen B. Land

Tax Exempt Bonds

Bruce M. Serchuk
Patti T. Wu

Tax Exempt Entities

Stuart L. Rosow
Michelle P. Scott

Tax Policy

David W. Mayo
Diana L. Wolfman

MEMBERS-AT-LARGE OF EXECUTIVE COMMITTEE

Andrew W. Braiterman
Peter J. Connors
Edward E. Gonzalez
Alysse Grossman

Mary L. Harmon
Sherwin Kamin
Elizabeth T. Kessenides
Charles I. Kingson

Gary B. Mandel
Douglas R. McFadyen
William L. McRae
David M. Schizer

Andrew P. Solomon
Richard R. Upton
Andrew Walker

October 16, 2006

Mr. Eric Solomon
Acting Assistant Secretary (Tax Policy)
Department of the Treasury
Room 3120 MT
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

The Honorable Mark W. Everson
Commissioner
Internal Revenue Service
Room 3000 IR
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: **"Report on "Zero Basis"**

Dear Acting Deputy Assistant Secretary Solomon and Commissioner Everson:

I am pleased to submit the New York State Bar Association Tax Section's Report No. 1120.

This report comments on Revenue Ruling 2006-2, 2006-2 I.R.B. 261, which revoked Revenue Ruling 74-503, 1974-2 C.B. 117, and announced that the "zero basis" conclusions set forth in that ruling are under study.

We agree that a reconsideration of those conclusions is appropriate, since the application of zero basis to the issuer's own stock or debt transferred in a carryover basis transaction results in the potential for tax on fictitious gains. Instead, we recommend that a fair market value basis apply in these circumstances, although additional rules, which will likely require legislation, are needed to prevent

FORMER CHAIRS OF SECTION:

Samuel Brodsky
Edwin M. Jones
Peter Miller
John E. Morrissey, Jr.
Martin D. Ginsburg
Peter L. Faber
Hon. Renato Beghe

Alfred D. Youngwood
Gordon D. Henderson
David Sachs
J. Roger Mentz
Willard B. Taylor
Richard J. Hiegel
Dale S. Collinson

Richard G. Cohen
Donald Schapiro
Herbert L. Camp
William L. Burke
Arthur A. Feder
James M. Peaslee
John A. Cory

Peter C. Canellos
Michael L. Schler
Carolyn Joy Lee
Richard L. Reinhold
Richard O. Loengard
Steven C. Todrys
Harold R. Handler

Robert H. Scarborough
Robert A. Jacobs
Samuel J. Dimon
Andrew N. Berg
Lewis R. Steinberg
David P. Hariton

Do the Public Good • Volunteer for Pro Bono

subsidiaries from taking advantage of a non-zero basis to trigger fictitious tax losses on sales of parent stock.

Because parent stock in the hands of a subsidiary resembles treasury stock in many respects, one could go further in developing rules that treat this stock as if it were not outstanding, in which case it would have no basis at all. While there are merits to this approach, this report does not address those further possibilities, since it is possible to deal with the infirmities of the zero basis approach without treating the parent stock as not outstanding.

The report provides detailed recommendations on preventing tax consequences from fictitious gains and losses attributable to changes in value of parent stock held by a subsidiary. The report also addresses how these rules should apply in the case of partially owned subsidiaries, partnerships owning stock of a corporate partner, and debt contributed to a subsidiary. We recognize, however, that when entities own stock or debt of their owners, the potential for unintended consequences is great, since most substantive provisions of tax law were drafted without this circumstance in mind. We therefore believe that there should be authority to provide anti-abuse rules that would alter the proposed basis rules in appropriate circumstances.

As discussed in our report, our principal recommendations are:

1. Stock of a corporate shareholder contributed to a corporation should have a fair market value basis in the hands of the transferee, and the basis of the shares received in exchange should also have a fair market value basis.
2. A set of basis adjustment rules should be provided so that a sale of parent stock by a subsidiary does not give rise to a taxable gain or a deductible loss, and so that changes in the value of parent shares held by the subsidiary are not taken into account in determining gain or loss on a sale of subsidiary stock by the parent.
3. These basis adjustment rules should apply in full where the subsidiary is at least 80% owned by the parent, and otherwise should apply on a proportionate basis. Below some lower threshold (between 20% and 50%), the basis adjustment rules should not apply at all.
4. Stock of a corporate shareholder contributed to a partnership should have a fair market value basis in the hands of the transferee, and the basis of the partnership interest received in exchange should also have a fair market value basis.
5. Section 1032 should be extended so that changes in value of a partner's stock held by the partnership are not taken into account in determining gain or loss from a sale of the partner's partnership interest.

6. The rules proposed above for a fair market value basis, and for subsequent basis adjustments, should apply regardless of whether the entities involved are domestic or foreign.

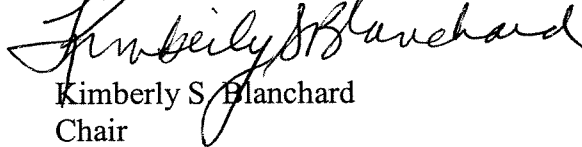
7. Debt contributed by its obligor to a corporation or partnership should have a basis in the hands of the transferee equal to its issue price, and the basis of the shares or partnership interest received in exchange should also reflect that issue price.

8. Where debt is issued to a related party, no gain or loss should be recognized when that debt is resold to a third party, and instead the debt should be treated as newly issued at the resale price for purposes of determining the issuer's original issue discount or premium, and similar rules should apply where the related party holding debt ceases to be related to the issuer.

9. The recommendations listed above for a fair market value basis in shares, and an issue-price basis in debt, contributed to a corporation or partnership in a tax-free transaction can be implemented without legislation, but it may be prudent not to adopt those recommendations until legislation can be enacted addressing the recommendations that prevent fictitious gains and losses.

We appreciate your consideration of our recommendations. If you have any questions or comments regarding this report, please feel free to contact us and we will be glad to discuss or assist in any way.

Respectfully submitted,



Kimberly S. Blanchard
Chair

Enclosure

Cc: Daniel L. Korb, Chief Counsel,
Internal Revenue Service
William D. Alexander, Associate Chief Counsel,
Internal Revenue Service
Marc A. Countryman, Senior Technician Reviewer,
Internal Revenue Service
Clarissa C. Potter, Senior Counsel to the Chief Counsel,
Internal Revenue Service