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August 24, 2004

The Honorable Members of the Finance Committee of the U.S. Senate
The Honorable Members of the Committee on Ways and Means of the U.S. House of Representatives
The Honorable John W. Snow

Subject: Senate JOBS Bill Amendments to Section 269

Ladies and Gentlemen:

I am writing on behalf of the Tax Section of the New York State Bar Association concerning section 435 of H.R. 4520, the Jumpstart Our Business Strength (JOBS) Act as passed by the Senate on July 15, 2004 ("JOBS Bill").[1] Section 435 of the JOBS Bill would expand the reach of section 269 of the Code. There is no comparable provision in the version of H.R. 4520 passed by the House on June 17.

Section 269 grants the IRS discretion to disallow tax benefits in certain corporate transactions the principal purpose of which is evasion or avoidance of federal income tax by securing a tax benefit that would not otherwise be enjoyed. The amendments would extend the disallowance rule to reorganizations and liquidations that take place between members of a corporate group. They would also prevent a taxpayer from defending against an IRS attack on the use of tax benefits in a transaction by showing that those benefits could have been enjoyed through other means (the "other means exception"), as discussed below. The changes would apply to stock and property acquired after February 13, 2003.

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1 The principal drafters of this letter were James M. Peaslee and Yaron Z. Reich. Comments were received from Kim Blanchard, Peter Blessing, Samuel Dimon, Kathleen Ferrell, Patrick Gallagher, Edward Gonzales, David Hariton, Richard Loengard, Deborah Paul, and Michael Schler.

The proposed amendments to section 269 stem from the Joint Committee on Taxation staff's February 2003 report discussing various tax-motivated transactions entered into by Enron Corporation ("Enron Report").[2] A common feature of these transactions is that they were not incidental to normal commercial transactions and involved tax benefits attributable to carryovers of built-in loss assets and loss duplication.[3]

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2 Joint Committee on Taxation, *Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations* (JCS-3-03), February 2003.

3 The main transaction that gave rise to the section 269 proposal was Project Cochise. It involved a transfer in a section 351 transaction of high-basis, low-value REMIC residual interests from Bankers Trust to a corporate subsidiary of Enron named Maliseet. Those assets were expected to produce phantom income in early years followed by losses in the later years. Maliseet also acquired income-producing assets. Maliseet elected REIT status so that it was not part of the Enron consolidated group. Its phantom income was allocated to Bankers Trust through consent dividends paid on the stock held by Bankers Trust. At a later point, the entity was expected to be recapitalized and brought into the Enron consolidated group so that Enron could benefit from losses from the residual interests. The main purpose of the transaction was to allow Enron to book financial statement earnings attributable to the anticipated future tax benefits. The transaction also allowed a duplication of losses in that the basis of Bankers Trust in the Maliseet stock it received in exchange for the residual interests reflected the high basis in those assets.

The tax opinion relating to the transaction assumed that the transfer of REMIC residual interests to Maliseet was subject to section 269(a)(2) (dealing with carryover basis transfers of assets to a corporation where the transferee does not control the transferor) but argued that the principal purpose of the transfer was not tax avoidance. (Section 269(a)(1) did not apply because Maliseet was a pre-existing subsidiary.) This conclusion was based primarily on the fact that future phantom losses of Maliseet would be attributable more to the post-acquisition income derived from the residual interests than from the pre-acquisition income (and the resulting basis). The benefits from post-acquisition income would have been realized even if Maliseet had purchased the residual interests in a fully taxable transaction. The opinion also notes that the profits to be derived from contributed assets plus the financial accounting benefits were substantial non-tax benefits and may have outweighed the tax benefits.

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Recommendations

We strongly support the Senate's objectives in preventing tax-motivated transactions of the type discussed in the Enron Report. However, we are concerned that, if enacted in their present form, the amendments would do more harm than good because they would subject new categories of transactions to a tax avoidance test without providing adequate standards for distinguishing illicit tax avoidance from permitted tax planning. Also, elimination of the other means exception could produce improper results in cases in which section 269 already applies.

Accordingly, if Congress decides to proceed with the section 269 changes, we recommend that the amended section not be effective until implemented through regulations, with an exception for clear abuse cases. Treasury and the IRS could then define more clearly through regulations which categories of transactions involve tax avoidance of the prohibited type and which do not. The regulations would be open to comment and review before adoption. Presumably, the regulations would include not only standards but also a number of examples. Abusive transactions that would be affected by amended section 269 with a current effective date should be defined by reference to the Enron Report as transactions that are not incidental to normal commercial transactions and involve tax benefits attributable to carryovers of built-in loss assets and loss duplication.

If the effective date is not delayed until implementing regulations are issued, then, at the least, we believe that the conference report should provide additional guidance on the intended scope of the statute. It would be helpful to state, for example, that the changes are aimed at tax avoidance transactions of the Enron variety that are not undertaken as

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Interestingly, it is not entirely clear whether the proposed amendments would have thwarted the Cochise transaction since the tax opinion in that transaction essentially concluded that the principal purpose of the transfer was not tax avoidance, and it is arguable to what extent that conclusion was based on the other means exception.

incidents of regular commercial activity and are not regarded as routine tax planning under current standards. In addition, we recommend that Congress explain the reasons for eliminating the other means exception. For example, we believe that it would be very helpful if the conference report were to include examples like those given in this letter and state that they do not involve tax avoidance of the type Congress has in mind. While courts differ on how much weight to give to legislative history, such a discussion, at the very least, would provide a basis for construing the statutory requirement of "avoidance".

Finally, if the effective date is not delayed until regulations are issued, we believe that the effective date should not be earlier than the date of enactment except in the abuse cases outlined in the second preceding paragraph. In particular, the Enron Report did not place taxpayers on notice that the section 269 amendments could affect transactions having little in common with the structured transactions described in that report.[4]

As an alternative to amending section 269, we believe that it would be possible to address many tax shelter transactions of the type highlighted in the Enron Report through objective, substantive law changes that do not present the same problems of potential vagueness and over-breadth as the proposed section 269 amendments do.[5] It is our understanding that

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[4] The press release issued by Senator Grassley in connection with issuance of the Enron Report (available at http://grassley.senate.gov/releases/2003/p03r02-13a.htm) states that "He put corporate America on notice by warning that today's date, Febr. 13, 2003, would be the effective date for any legislation proposed to shut down the kind of tax schemes identified in the report."

[5] In terms of uncertainty of outcomes and risk of over-breadth, the proposal has some of the same drawbacks as the economic substance codification proposal found in section 401 of the JOBS Bill, which we commented on in a letter and report in May 2003. See "Summary Report on the Provisions of Recent Senate Bills That Would Codify the Economic Substance Doctrine," Report No. 1032, May 21, 2003, and accompanying letter. Our May 2003 submission noted that many tax shelters use common techniques (such as carrying over high-basis assets to new taxpayers) that could appropriately be curbed through legislation, and expressed our readiness to assist the Treasury, Congress and the IRS to develop effective substantive measures.

Congress has had under review for some time a number of alternative measures (not now incorporated in any legislation) that would impose limitations on transactions of this type based on objective rules (that is, rules that do not depend on motive or the existence of "tax avoidance" or similar tests).[6] We recommend that Congress make public the various alternatives that are under active consideration and request comments on them (even if the time available for a response is short). We stand ready to work with the Treasury, Congress and IRS to provide assistance in this area (either through reports or, if, at this late stage, there is not time, informally).

The balance of this letter will describe section 269 and the proposed changes and set forth in more detail the reasons for our recommendations.

Description of Section 269 and Proposed Changes

Section 269 applies to three types of transactions: acquisitions of control of a corporation, acquisitions of assets by one corporation from another with a carryover basis where the transferor is not controlled by the transferee or its stockholders, and liquidations occurring within two years after a qualified stock purchase. If the principal purpose of a taxpayer in effecting one of these transactions is evasion or avoidance of federal income tax by securing a tax benefit that would not otherwise be enjoyed, then the IRS may deny the benefit.

The JOBS bill would expand section 269 in two ways. First, it would extend the section to carryover basis transfers of assets by one corporation to another in which the transferee or its stockholders control the transferor. Second, it would permit the disallowance of tax benefits arising from a transaction covered by the section (under current law or as a result of the first change just described) even if the taxpayer could enjoy

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6 Section 431 of the JOBS Bill would limit the carryover of built-in losses in various corporate transactions. An analysis of this provision is beyond the scope of this letter.

those benefits through other means.[7] The first change would have the effect of introducing into the Code a general purpose, motive-based tax avoidance test applicable to internal group reorganizations and subsidiary liquidations.[8] The elimination of the other means exception would allow tax benefits to be denied in a transaction subject to section 269 even though they could have been achieved in a different way. In other words, the specific route chosen by a taxpayer to achieve a particular tax benefit would be critical to the outcome.

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7 The JOBS Bill would repeal the other means exception by deleting the following italicized words from section 269: "and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax *by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy*." This clause has been construed by courts and the IRS to mean that section 269 does not apply if the taxpayer could have received the same tax benefit via an alternative transaction method not implicating section 269. See, e.g., *Cromwell Corp. v. Comm.*, 43 T.C. 313 (1964) (holding that the tax benefit the taxpayer received from filing consolidated returns could have been achieved by several feasible methods and, thus, section 269 is inapplicable); *Zanesville Inv. Co. v. Comm.*, 335 F.2d 507 (6th Cir. 1964) (same); Revenue Ruling 63-40, 1963-1 C.B. 46 (holding that the taxpayer may use its prior net operating losses after an acquisition of a new business enterprise regardless of which of two acquisition methods taxpayer chose); General Counsel Memorandum 39472 (Aug. 2, 1985) (stating that section 269 applies to a transaction only if the taxpayer obtains a tax benefit as a result of the transaction that the taxpayer would not otherwise enjoy). See generally Boris I. Bittker and James S. Eustice, *Federal Income Taxation of Corporations and Shareholders*, Warren, Gorham & Lamont, 7th Ed., ¶ 14.41[5].

8 Under current law, section 269 applies to "downstream" intragroup transactions involving acquisitions of corporations or carryover basis transfers of assets to subsidiaries (transfers in which the transferor is not controlled by the transferee or its shareholders). The change would expand the scope of section 269 to cover asset transfers between sister companies and liquidations. As illustrated by Examples 1 and 2, below, the elimination of the other means exception could also significantly affect downstream intragroup transactions already covered by section 269. For a further discussion of the treatment of downstream transactions under current law, see footnote 16, below.

The discussion of the amendment in the Senate Finance Committee report on the JOBS Bill is brief.[9] It states that the Enron Report highlighted the limited reach of section 269, and it expresses a general desire to expand the scope of section 269.[10] The elimination of the other means exception is not mentioned. The Senate Report does not give any examples of, or other guidance on, the types of tax-motivated transactions that are expected to be affected or not affected by the change.

The Enron Report includes a lengthy discussion of certain structured transactions that gave rise to the recommended change in section 269. Those transactions involved transfers of high-basis, low value property occurring in tax-motivated transactions that were not related to the business of Enron. Section 269 has traditionally been used to attack transactions of this type, and it appears likely that the drafters had them primarily in mind in proposing an expansion of section 269. However, there is nothing in the Enron Report or the Senate Report stating that the reach of expanded section 269 would be limited to transactions of that type.

The potential consequences of the proposed amendments may be illustrated with four examples. These examples all involve tax planning that is incidental to commercial transactions. Under current law and practice, the tax planning steps in these examples should have the desired results. Further, in our view, those results are appropriate. What would

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9 See Sen. Rep. No. 108-192, 108th Cong. 1st Sess., 147-148 ("Senate Report").

10 Under the heading "Reasons for Change," the Senate Report states the following: "Present-law section 269, as it applies to the acquisition of property, is circumscribed because it only applies to tax benefits that can be obtained through the acquisition of control. The Committee believes it is appropriate to expand section 269 by the removal of such requirement." The "Explanation of Provision" states that the provision "expands section 269 by repealing the requirement that the acquisition of property be from a corporation not controlled by the acquirer." Note that the Enron Report had recommended that the control requirement be eliminated from section 269(a)(1) as well as (a)(2), so that the section would apply to any acquisition of stock of a corporation, including a portfolio investment. This change is not included in the JOBS Bill.

the consequences be under amended section 269? We doubt that the drafters intended to change the outcomes, but the proposed changes could well have that effect.

> **Example 1.** A group of individual investors wish to purchase the stock of unrelated domestic corporation T for cash. T has substantial earnings and profits. The investors set up corporation P and contribute funds to it in exchange for stock. P borrows money and buys the stock of T. Immediately thereafter, P causes T to borrow against its assets and pay a dividend to P to allow P to repay its debt. P and T join in a consolidated return, so that the dividend is eliminated in consolidation. If the investors had incurred the debt and purchased T directly, they would have been taxable on the dividend income.

Example 1 is based on *Cromwell Corp. v. Comm.*, 43 T.C. 313 (1964). In that case, the IRS invoked section 269 to challenge the exclusion of the dividend paid by T to P from the income of the investors. There was clearly an acquisition of control of a corporation (P and, if relevant, T) within the meaning of section 269. The issue then was whether the benefit (tax-free dividend) was one that fell within the scope of section 269. The taxpayers argued that the use of one corporation to acquire another is a conventional business practice, that they met the requirements for filing a consolidated return, and that section 269 could not deprive them of the privilege of filing a consolidated return. The court held for the taxpayer, on the ground that, irrespective of purpose, there had been no securing of a benefit that would not otherwise be enjoyed. The court explained that there were other ways to accomplish a bootstrap acquisition without dividend income. The tax benefit was therefore not attributable to the acquisition of control. As indicated above, amended section 269 would eliminate the other means exception on which the court based its holding. Presumably for that reason, Bittker and Eustice in their corporate tax treatise describe the proposal in the Enron Report to eliminate this exception as "apparently an attempt to overrule

the *Cromwell* decision."[11] If so, this is very troubling because it is unclear what would be considered permissible tax planning under amended section 269.

> **Example 2.** Domestic corporation P owns all of the stock of domestic corporation S. P and S do not file a consolidated return. S has net operating losses, and P contributes an income-earning business to S, primarily in order to offset the income with the losses.

Example 2 involves a carryover basis asset transfer of a type that is covered by section 269(a)(2) under current law (because S does not control P). However, the contribution of an income-producing group of assets to a subsidiary should not result in a limitation on the use of losses under current law because P could have achieved the same result by converting S into an LLC and liquidating S into P for tax purposes.[12] This other means exception would no longer exist under amended section 269. Also, if section 269 were extended to liquidations, the argument would become circular, because it would be necessary to apply section 269 to the hypothetical liquidation to determine if losses could be combined with income through that route.

> **Example 3.** P, a domestic corporation, owns all of the stock of foreign corporation F, the parent of an operating group. F has a number of foreign operating subsidiaries. P causes various F operating subsidiaries to check-the-box to convert into branches of F for federal income tax purposes. The reason for the change is to allow

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[11] Boris I. Bittker and James S. Eustice, *Federal Income Taxation of Corporations and Shareholders*, Warren, Gorham & Lamont, 7th Ed., 2004 Cum. Supp. No. 1, S14-7.

[12] See Treasury Regulation § 1.269-3(c)(2) (similar example held to involve tax avoidance subject to section 269 where P would *not* succeed to S's losses if S were liquidated into P, e.g., because P does not own enough stock of S to qualify under section 332 or had recently purchased S stock, so that a liquidation would have been treated as an asset purchase under pre-1986 section 334(b)(2)).

the netting of income and losses in F and to avoid adverse subpart F consequences of intragroup transactions.

Example 4. P, a domestic corporation, owns 100 percent of S, another domestic corporation, which engages in a manufacturing business. S has depreciable property that has declined in value in recent years. P intends to sell the stock of S to an investment partnership, IP. P wants to treat the sale as an asset sale in order to claim an ordinary deduction on the sale of section 1231 assets held by S. However, it is costly and impractical to physically transfer assets and liabilities of S. The parties cannot address the problem by making a section 338(h)(10) election because IP is not a corporate buyer (and does not want to operate the S business through a corporation). To solve the problem, P converts S into a limited liability company immediately prior to the sale and sells to IP all of the equity in the LLC. The conversion is treated as a section 332 liquidation of S into P, with the result that P is considered for tax purposes to sell to IP the assets acquired from S.

The liquidations of F and S in Examples 3 and 4 involve a carryover basis transfer of assets to F or P, as the case may be, and the sole purpose for the transfer is to achieve a tax saving. Under current law, section 269 would not apply because F/P controls its subsidiaries prior to the liquidation.[13] Once the control exception is removed, the liquidations would be caught. Further, the fact that the same tax result could have been achieved in Example 4 through a direct asset sale would not be a defense under the amended section.[14]

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13 See *Dover Corporation v. Comm.*, 122 T.C. 324 (2004) for a discussion of non-section 269 issues raised by transactions similar to those described in Examples 3 and 4.

14 P might also argue that the principal purpose of the conversion was not tax reduction but rather a desire to avoid a physical asset sale. However, the asset sale could have been avoided by selling stock of a corporation, so the conversion to an LLC appears to have only a tax motive.

We anticipate that if section 269 were amended, the taxpayers in all four examples would argue that they are still unaffected by the section, on the ground that the transactions do not involve "avoidance" of federal income tax of the type addressed by section 269. There are authorities applying the section that confirm that section 269 may not be applied to deny special benefits afforded by Congress because achieving intended benefits is not tax avoidance.[15] In light of these authorities, we believe that even if section 269 were amended as proposed, it would be difficult for the IRS to use section 269 to deny wholesale tax benefits associated with the decision to operate through a corporation or to convert a corporation into a pass-through entity. Accordingly, we do not believe that amended section 269 would be applied to deny taxpayers the basic entity classification elections that are available under the current check-the-box system. On the other hand, it is not as clear whether the ancillary benefits of operating through a corporation or a branch of the type at issue in the examples above would be protected. Most practitioners would certainly argue that they should be, but we believe the outcome would not be clear. The answer may depend on how good a record a taxpayer could establish that the particular benefit at issue was intended by Congress and how a court would view the intent of Congress in expanding the scope of section 269 and eliminating the other means exception.

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[15] See, e.g., Revenue Ruling 70-238, 1970-1 C.B. 61 (use of Western Hemisphere trade corporation); Revenue Ruling 76-363, 1976-2 C.B. 90 (S election); *Achiro v. Comm.*, 77 T.C. 881 (1981) (use of corporation to achieve pension benefits in setting where Congress had considered the issue). In *Siegel v. Comm.*, 45 T.C. 566 (1966), the court held that the IRS could not apply section 269 in an era before subpart F to tax a U.S. shareholder of a foreign corporation on income received by the corporation on the theory that the corporation had been formed principally to deflect the income. The court, however, did not rely on the absence of tax avoidance. Instead, it found that the shareholder had a non-tax motive for creating the corporation (to limit liability) and that the exclusion of an amount from income was not an "allowance". The current regulations define "allowance" very broadly to mean anything in the internal revenue laws which has the effect of diminishing tax liability. Treasury Regulation § 1.269-1(a).

Reasons for Recommendations

This section discusses in more detail three reasons for our recommendation that the proposed section 269 amendments either be modified as described above so as to have the applicable standards clearly articulated by Congress and/or by regulations before they become generally effective, or that the proposed amendments be replaced with objective, substantive provisions addressing the type of tax-motivated transactions identified in the Enron Report. Our reasons relate to (i) the lack of standards for distinguishing tax avoidance from tax planning under the proposed expansion of section 269, (ii) historic difficulties in applying the "tax avoidance as principal purpose" test, and (iii) the role that the IRS would assume in interpreting and enforcing an expanded section 269. These points have a common theme, which is that expanded section 269, in the form set forth in the proposed amendments and without any additional guidance, would be difficult to apply and is not well targeted to abuse cases.

Lack of Standards. While the language of section 269 is very general, the section has been applied most often in the past to limit trafficking in tax benefits (including most prominently, loss carryovers and built-in losses). Trafficking means shifting tax benefits from one group of economic interests to another. Viewing the section in that light, the current-law exception for carryover basis transfers of assets between corporations under common control is readily understandable. The same policy is reflected in section 382, which limits the use of tax benefits following a more-than-50-percent change in the beneficial ownership of a loss corporation.

The proposed elimination of the common control exception implies a shift in the focus of section 269 from an anti-trafficking rule to something else. It is not clear, however, what the new paradigm is. It can fairly be inferred that the drafters were motivated to propose the change by a desire to curb Enron-style tax motivated, structured transactions. However, the elimination of the common control exception is not tailored to transactions of that type, and the statute and Senate Report do not distinguish one type of tax avoidance transaction from another. Also, we

do not understand the rationale for eliminating the other means exception. If the IRS decided to apply an expanded section 269 vigorously to intragroup transactions that are incidental to commercial activity but undertaken mainly to reduce taxes (e.g., the four examples above), it would be quite difficult for a court to find a principled reason anchored in the statutory text or legislative history to stand in the way. Thus, IRS discretion would be key.

In the past, taxpayers have often dealt practically with section 269 by finding a business purpose for a transaction that was good enough to at least discourage the IRS from asserting section 269 except in clearly abusive cases. The advent of the check-the-box rules makes it important that the legal standards for applying any expanded version of section 269 be articulated clearly. The purpose of the check-the-box system was to allow taxpayers to choose initially the tax classification of entities, and to change their classification, by filing or not filing a form. Because the election has no non-tax consequences, the purpose of the election is necessarily tax motivated. In adopting the elective system, the Treasury and IRS clearly believed that taxpayers had the right to achieve tax advantages through changes in entity classification, at least in some circumstances. Without a further articulation of standards, section 269 is a very blunt instrument for drawing the line between permitted and impermissible choices. Although section 269 does apply today to incorporation transactions, expanding the categories of transactions to which it applies and eliminating the other means exception would add greatly to the risk of unintended results.

Principal Purpose Test. In considering the wisdom of expanding section 269 with a retroactive effective date and without clearly articulating standards for its application, it is instructive to consider the history and effectiveness of that provision. Section 269 has been criticized for years by both taxpayers and government representatives on the ground that the "tax avoidance as the principal purpose" test is subjective and therefore fact intensive and difficult to apply in practice. Responding to those criticisms, sections 382 and 383 were adopted to provide objective rules for curbing trafficking in tax attributes. Those sections were themselves overhauled in 1986 after a thorough review. Following the

1986 changes, section 269 has played a less significant role than was previously the case. We believe this is a welcome development. A proposal to reinvigorate section 269 without providing, in advance, clear standards for its application should take into account past problems with the principal purpose test. Indeed, consideration of the history of section 269 may suggest that, rather than adopting the proposed amendments, it may be more efficacious to address the tax shelter transactions of the type highlighted in the Enron Report through objective, substantive law changes that do not present the same problems of potential vagueness and over-breadth as the proposed section 269 amendments do.

Role of the IRS. The proposed amendments – with their retroactive effective date and lack of clear standards – would effectively delegate substantial authority to IRS agents to allow or disallow tax benefits in a range of corporate transactions simply by deciding whether or not to raise a section 269 challenge. We believe it would be misguided to grant such authority to the IRS without first articulating standards (or requiring the IRS to articulate standards through regulations) for applying it. We are also quite concerned that the absence of such articulated standards, which could persist for an extended period of time, will result in the tax law being made in the field, with some examiners routinely mounting section 269 challenges and others not. Given such lack of standards, practices will surely differ among agents, creating a material risk of disparate treatment of similarly-situated taxpayers. Indeed, we believe that there is a significant risk of examiners using the threat of section 269 as a way of bargaining for concessions on unrelated matters.[16]

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[16] As indicated above, section 269 already applies to downstream transfers of assets within a group, and one question is why the adverse results spelled out in the text do not arise in practice under current law. There are several answers to the point. Contributions of assets to existing corporations often have some non-tax purpose. A case in which assets are transferred without a non-tax purpose by checking the box often involves taking advantage of the core benefits of having a separate corporation (e.g., deferral of income earned through a foreign corporation) where the argument that any tax reductions do not amount to "avoidance" is supported by long-standing practice. A contribution of assets to offset income with losses may be protected under the other means exception (cont'd)

While it might be thought that a broad delegation of authority to the IRS is something the tax administrator would want, we believe that such a delegation, with a retroactive effective date and a lack of clear standards, would impose real burdens on the IRS and Treasury to sort out how the authority will be used and to respond to taxpayer requests for guidance. We do not think that tax advisors will respond to the change by waiting to see how it will all sort out in audits and court cases over a period of many years. Rather, they will push the IRS vigorously to take action to articulate standards, or at least practice guidelines. It will be a serious challenge for the IRS and Treasury to determine how to respond given the vague language of the section and the lack of direction from Congress.

The need for the IRS to address concerns with overly broad anti-abuse rules is illustrated by a recent regulation project under section 367(e)(2). That section provides that, unless otherwise provided in regulations, a corporation distributing appreciated property in a section 332 liquidation to a foreign corporation is required to recognize gain. The IRS issued final regulations under this section in 1999 that generally required gain recognition in the case of distributions by domestic corporations, but not in the case of liquidations of foreign corporations (with certain exceptions). The regulations included an anti-abuse rule stating that the IRS might require a domestic or foreign corporation to recognize gain on a liquidation into a foreign corporation (notwithstanding contrary exceptions) "if a principal purpose of the liquidation is the avoidance of U.S. tax (including, but not limited to, the distribution of a

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(see Example 2 above). However, we fear that the extension of section 269 to a new set of circumstances involving new substantive issues, combined with the elimination of the other means exception, may lead to a comprehensive reassessment of section 269 by the IRS and taxpayers that will create substantial uncertainty as to the proper treatment of a number of common transactions. This uncertainty could carry over to areas in which section 269 already arguably applies as a technical matter but that are not thought to pose a serious threat of successful challenge today.

liquidating corporation's earnings and profits with a principal purpose of avoiding U.S. tax)."[17]

In 2002, the IRS proposed a change in the anti-abuse rule, limiting it to liquidations of domestic corporations. The change was finalized in 2003.[18] The preamble to the proposed regulations states that the IRS received comments objecting to the anti-abuse rule as applied to foreign-to-foreign liquidations, on the ground that it was overly broad and prevented taxpayers from engaging in legitimate business transactions. The IRS agreed that foreign-to-foreign liquidations should result in gain recognition only in particular and limited circumstances and narrowed the rule to liquidations of domestic corporations.[19]

The section 367(e) regulation adopted an anti-abuse rule applicable to a particular category of liquidations. The rule was too broad, and the IRS recognized the problem and narrowed the rule through subsequent changes to the regulations. Given the potential of an expanded section

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17 Treasury Regulation § 1.367(e)-2(d), as adopted by T.D. 8834, 1999-2 C.B. 251.

18 The final regulation was adopted by T.D. 9066 (July 2, 2003). The proposed regulations are at 2002-2 C.B. 969 (November 20, 2002).

19 The preamble includes the following (2002-2 C.B. 969-970):

"Since the final regulations were issued [in 1999], various commentators have expressed concern that the anti-abuse rule is overly broad because it is not limited by its express terms to outbound liquidations. Specifically, it has been brought to the attention of Treasury and the IRS that uncertainty regarding the potential application of the anti-abuse rule is preventing taxpayers from engaging in legitimate business transactions involving foreign-to-foreign liquidations. Although the preamble to the final regulations does not address any circumstances in which the anti-abuse rule would apply to a foreign-to-foreign liquidation, the rule by its express terms could so apply. Application of this rule to require gain recognition in a foreign-to-foreign liquidation is not consistent with the approach of the final regulations that require gain recognition in the case of a foreign-to-foreign liquidation only in particular and limited circumstances. Accordingly, these proposed regulations would amend the anti-abuse rule to limit its application only to outbound liquidations."

269 to chill legitimate business transactions, we believe that the wiser course would be to define the scope of that provision at the outset, rather than relying on a process of after-the-fact narrowing of its applicability.

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We appreciate your consideration of these comments. Please feel free to contact me if we can provide further assistance regarding this matter.

Respectfully submitted,

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