June 30, 2004

Gentlemen:

I am writing on behalf of the Section of Taxation of the American Bar Association concerning recent proposals considered by Congress in connection with pending tax legislation. The views expressed herein represent the position of the Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Specifically, I write with respect to S. 1637 and H.R. 4520, which have been approved in the past month by the Senate and the House of Representatives, respectively. Each of these bills is intended, among other things, to bring the United States into compliance with the World Trade Organization’s rulings on the FSC/ETI provisions. As you move forward to resolve your differences on these two bills, the Section of Taxation respectfully requests that you take into account the following significant points.

First, we note that section 401 of S. 1637 would attempt to codify the economic substance doctrine. There is no corresponding provision in H.R. 4520. To the extent that the Congress ultimately decides to take any action in this regard, it should be limited to clarifying that when a court determines that the economic substance doctrine does apply, (i) the taxpayer must establish that the non-tax considerations in the transaction were substantial in relation to the potential tax benefits; and (ii) in evaluating the potential economic profit from the transaction, all costs properly allocated to the transaction (including fees paid to promoters and advisers) should be taken into account.

Second, we continue to have concerns regarding other provisions contained in S. 1637, on which we also wrote last year. Specifically, section 435 of S. 1637 would amend section 269 of the Internal Revenue Code principally by repealing the “control” requirement. The result would be to empower the Secretary to disallow tax benefits resulting from certain acquisitions of stock of a corporation, and any acquisition of property by a corporation from another corporation in a transferred basis transaction, where the transaction meets the “principal purpose” test of section 269. To totally discard the historic requirement that limits this broad and powerful authority to transactions involving acquisitions of control...
would expand it to a new universe of transactions, adding an automatic element of uncertainty to virtually every transaction involving an acquisition of stock. A change in Section 269 in the way proposed as to asset acquisitions would subject virtually every incorporation and acquisitive reorganization to new scrutiny as well. There is no corresponding provision in H.R. 4520.

Separately, section 431 of S. 1637 would amend section 362 of the Code by reducing the aggregate adjusted basis of property contributed to a corporation in a section 351 incorporation to the aggregate fair market value of the property. This new treatment would drastically change the transferred basis regime that has applied to corporate transactions for decades, and would have a punitive effect on non-abusive transactions. Although incorporation has been historically recognized as a mere change in form of businesses with a carryover of tax attributes, the proposal would, in many instances, cause a significant substantive impact that negates the potential use of the corporate form because of the loss of basis upon incorporation. It would cause some corporations to recognize undue amounts of gain, and force many to obtain expensive and otherwise unnecessary asset appraisals. It could prove to be a costly trap for the unsophisticated or ill-advised taxpayer who incorporates for legitimate business reasons, where the transferred assets reflect significant current built-in losses due to economic conditions. A number of anti-abuse mechanisms already exist for restricting the ability of taxpayers to utilize losses. Disrupting the similar treatment of built-in-gain and built-in-loss in commonplace transactions is neither necessary nor appropriate. There is no corresponding provision in H.R. 4520; however, we note that section 636 of H.R. 4520, which would limit the ability to transfer built-in losses in REMIC residual interests, is a more targeted provision, which appears intended to address a specific abuse.

Third, we continue to support efforts to modernize the rules applicable to subchapter S corporations. We appreciate your consideration of the comments we submitted last year in this regard, a copy of which are enclosed with this letter, and appreciate the inclusion of some of these provisions in H.R. 4520.

Finally, but certainly not least, we continue to support your efforts to address the significant systemic problems caused by the varying definitions of a “child” for purposes of the earned income tax credit, dependency exemption and other family status related provisions of the Code. We understand that these provisions are contained in H.R. 1528, as approved by the Senate in May, and we support any efforts that you can make to ensure that these important changes are enacted this year.

We appreciate your consideration of these comments. Representatives of the Section would be pleased to discuss them in further detail with you or members of your respective staffs. Please contact Stuart Lewis, the Section’s Vice-Chair for Government Relations, at (202) 452-7933 if that would be helpful.

Sincerely,

Richard A. Shaw
Chair, Section of Taxation

Enclosures

cc: Hon. John Snow, Secretary of the Treasury
Gregory Jenner, Acting Assistant Secretary of the Treasury (Tax Policy)
George Yin, Chief of Staff, Joint Committee on Taxation
Kolan Davis, Republican Staff Director and Chief Counsel, Senate Finance Committee
Russ Sullivan, Democratic Staff Director, Senate Finance Committee
Robert Winters, Republican Chief Tax Counsel, House Ways and Means Committee
John Buckley, Democratic Chief Tax Counsel, House Ways and Means Committee