

TREASURY TURNS BACK THE CLOCK ON 2016 TAX REGULATIONS

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U.S.
Tax Reform

SECOND REPORT TO THE PRESIDENT ON IDENTIFYING AND REDUCING TAX REGULATORY BURDENS – EXECUTIVE ORDER 13789

On October , the “other shoe dropped” on eight regulations issued by the Obama administration in 2016 and January 2017. These eight measures were first identified in an interim Report to the President as unnecessary, unduly complex, excessively burdensome, or failing to provide clarity and useful guidance. They will be withdrawn, revoked, or modified as explained below.

The Treasury Department also announced the initiation of a comprehensive review of all tax regulations, regardless of when they were issued. Included in the expanded review are longstanding temporary or proposed regulations that have not expired or been finalized but which to varying degrees appear to be unnecessary, duplicative, or obsolete. The rulemaking process for revoking regulations will begin in the fourth quarter of 2017.

WITHDRAWAL OF PROPOSED REGULATIONS

Withdrawal of Proposed Regulations Under Code §2704 on Restrictions on Liquidation of an Interest for Estate, Gift, and Generation-Skipping Transfer Taxes (REG-163113-02; 81 F.R. 51413)

Code §2704 addresses the valuation, for wealth transfer tax purposes, of interests in family-controlled entities. In limited cases, it disregards certain restrictions on the ability to dispose of or liquidate family-controlled entities when determining the fair market value of an ownership interest for estate tax, generation-skipping transfer tax, and gift tax purposes. Over the years, changes in state statutory law and case law eroded the scope of its application, thereby facilitating the use of artificial valuation discounts such as lack of control and limited marketability. The proposed regulations would have narrowed the use of these valuation discounts. However, the Treasury and the I.R.S. now believe that the proposed regulations are unworkable and the burden of compliance is excessive. The proposed regulations will be withdrawn in their entirety.

Withdrawal of Proposed Regulations Under Code §103 on Definition of Political Subdivision (REG-129067-15; 81 F.R. 8870)

Code §103 excludes from a taxpayer’s gross income the interest on state or local bonds, including obligations of political subdivisions. Code §103 does not define “political subdivision.” However, the case law requires a political subdivision to possess and exercise sovereign powers. The proposed regulations would have required a

political subdivision to meet enhanced standards to show a governmental purpose and governmental control in addition to significant sovereign power. Although some enhanced standards for qualifying as a political subdivision may be appropriate, the proposed regulations will be withdrawn in their entirety because of their far-reaching impact on existing legal structures.

REVOCATION OF REGULATIONS

Partial Revocation of Final Regulations Under Code §7602 on the Participation of a Person Described Code §6103(n) in a Summons Interview (T.D. 9778; 81 F.R. 45409)

Final regulations under Code §7602 provide that the I.R.S. may use private contractors (*i.e.*, nongovernment employees) to assist the I.R.S. in auditing taxpayers. The regulations also allow private contractors to receive and review records produced in response to a summons, be present during interviews of witnesses, and question witnesses under oath, under the guidance of an I.R.S. officer or employee. Although, the court in *United States v. Microsoft Corp.*, upheld the I.R.S.'s legal authority to enlist outside attorneys, it expressed its concern regarding the law firm's level of involvement in the audit. The Treasury and the I.R.S. intend to amend these regulations in order to narrow their scope by prohibiting the I.R.S. from enlisting outside attorneys to participate in an examination, including a summons interview. However, the regulations would continue to allow outside subject-matter experts, such as an engineer or foreign attorney who is a specialist in foreign law, to participate in summons proceedings. They explained that since the experts have a circumscribed role in providing subject-matter knowledge, the government does not risk losing control of its own investigation.

Partial Revocation of Regulations Under Code §§707 and 752 on Treatment of Partnership Liabilities (T.D. 9788; 81 F.R. 69282)

These proposed and temporary partnership tax regulations govern how liabilities are allocated for purposes of disguised sale treatment and whether bottom-dollar guarantees create sufficient economic risk of loss necessary to be considered as a recourse liability. These rules proposed a novel way of allocating liabilities without a full analysis of its impact on areas beyond disguised sales. The proposed and temporary regulations will be revoked, while further study is given to the approach. In the interim, prior regulations will be reinstated.

Partial Revocation of Final and Temporary Regulations Under Code §385 on the Treatment of Certain Interests in Corporations as Stock or Indebtedness (T.D. 9790; 81 F.R. 72858)

These final and temporary regulations address two separate parts of Code §385. One part relates to the documentation regulations that establish minimum requirements for purported debt obligations among related parties to be treated as debt for Federal tax purposes. These regulations compel corporations to build expensive new systems to satisfy numerous tests related to documentation. They will be revoked and replaced by simplified and streamlined rules that would lower the burden on U.S. corporations while producing information sufficient for tax administration purposes. The other part involves indebtedness to fund distributions. These principally address inversions and takeovers of U.S. corporations, by limiting the ability

of corporations to generate additional interest deductions without new investment in the U.S. The Treasury continues to firmly believe in maintaining safeguards against earnings stripping. However, the solution requires a legislative change to fix the structural deficiencies in the current U.S. tax system that incentivize inversions in order to eliminate the need for earnings of foreign subsidiaries to be locked in those subsidiaries. Tax reform is expected to obviate the need for the distribution regulations and make it possible for these regulations to be revoked. If a legislative solution is not achieved, the Treasury and the I.R.S. may propose more streamlined and targeted regulations.

SUBSTANTIAL REVISION OF REGULATIONS

Substantial Revisions to Final Regulations Under Code §367 on the Treatment of Certain Transfers of Property to Foreign Corporations (T.D. 9803; 81 F.R. 91012)

These temporary regulations amend existing rules on transfers of property by C-corporations to Real Estate Investment Trusts (“R.E.I.T.’s”) and Regulated Investment Companies (“R.I.C.’s”), generally in accordance with provisions of the Protecting Americans from Tax Hikes Act of 2015. The Treasury and the I.R.S. believe that R.E.I.T. spin-off rules could result in over-inclusion of gain where a large corporation acquires a small corporation that engaged in a spin-off under Code §355 and the large corporation subsequently makes a R.E.I.T. election. Revisions will limit the potential taxable gain so that it does not exceed the amount that would have been recognized if a party to a spin-off had directly transferred assets to a R.E.I.T. Only gain related to the assets of the corporation undergoing the spin-off will be recognized.

Substantial Revisions to Final Regulations Under Code §987 on Income and Currency Gain or Loss with Respect to a Code §987 Qualified Business Unit (T.D. 9794; 81 F.R. 88806)

Under existing regulations, currency gains or losses of a branch are recognized when the branch makes certain transfers of property to its head office. Under a transitional rule, previously unrecognized currency losses in years prior to the transition period are disregarded in the computation. In addition, the rules are unduly complex. The Treasury and the I.R.S. will issue rules allowing taxpayers to defer application of the regulations until 2019, at the earliest. A simplified method to compute the recognized currency gain will be developed. The transitional rule may be revised to provide alternative methods of computing the gain.

