



Securities Industry Association

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December 17, 2002

Internal Revenue Service
Room 5226
Post Office Box 7604
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CC: ITA: RU

Re: New Temporary and Proposed Regulations Relating to Disclosure and Listing of Tax Shelter Transactions (REG-103735-00, REG-154117-02, REG 154116-02, REG- 154115-02, REG 154429-02, REG 154423-02, REG-154426-02, REG 110311-98, REG-103736-00)

Ladies and Gentlemen:

We are writing in regard to the temporary and proposed regulations issued on October 17, 2002 with respect to the disclosure and listing of "tax shelter" transactions (herein, the "Disclosure Regulations" and the "Listing Regulations"). Our comments focus primarily on those aspects of the regulations that affect members of the Securities Industry Association (the "SIA")¹ in their capacities as financial intermediaries and financial advisors, or as to which these roles give us a unique perspective.

As an initial matter, we would like to express our appreciation for the consideration that the Internal Revenue Service ("IRS") and the Treasury Department have given to our previous comments on earlier versions of these regulations. With respect to the Listing Regulations in particular, our principal concerns have been

¹ The Securities Industry Association brings together the shared interests of more than 600 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. Collectively they employ more than 495,000 individuals, representing 97 percent of total employment in securities brokers and dealers. The U.S. securities industry manages the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2001, the industry generated \$280 billion in U.S. revenue and \$383 billion in global revenues.

addressed, and we have only a few additional suggestions. These suggestions are outlined below, followed by our comments on the Disclosure Regulations.

A. Comments on the Listing Regulations.

As indicated above, the Listing Regulations address our principal concerns with the administrability of earlier versions of those regulations. The comments set out below are principally in the nature of clarifications or points intended to enhance compliance.

1. Written Material.

With regard to the Listing Regulations, we suggest that the IRS and Treasury Department clarify that the “additional written materials” required to be retained in connection with a transaction subject to list maintenance² consist only of written materials that pertain to the “structure or tax aspects” of the transaction and not to any materials that relate to the transaction but have no bearing on either of these aspects. For example, a law firm that is a material advisor with respect to a corporate acquisition may produce a memorandum discussing environmental liabilities or regulatory implications, which would not be relevant to a later examination of the tax consequences of the transaction. Similarly, e-mails or written correspondence with regard to administrative matters such as scheduling (e.g., announcing the time of a conference call or meeting, or proposing a deadline for response by another party) or contact information (e.g., a working group list) would seem to have no bearing on the tax treatment of a transaction. Accordingly, we assume that the IRS and Treasury Department did not intend to require that such memoranda or other correspondence be retained as part of the list.

Similarly, we suggest that, where a document does bear on the structure or tax aspects of the transaction, consideration be given to limiting the retention requirement to the final (and executed, in the case of a contract) version of the document. Documentation relating to large or complex transactions may go through multiple revisions during the negotiation phase, leading to multiple drafts of lengthy agreements. A superseded, unexecuted version of a transactional document has no bearing on the actual terms of the transaction and thus should not have to be retained in the listing file. Memoranda addressing legal (including tax) aspects of a transaction also present similar concerns.

2. Effective Date.

We request that the IRS and Treasury Department extend the effective date of the Listing Regulations to 90 days after the publication of final rules. The Listing Regulations will require affirmative action by material advisors immediately upon the

² See Temp. Treas. Reg. § 301.6112-1T(e)(3)(I).

regulations' becoming effective. Advisors will need to determine whether particular transactions meet the criteria for list maintenance and, if so, begin immediately to retain the required materials. This will necessitate establishing compliance systems to gather and preserve the materials, as well as educating personnel regarding the listing criteria and record retention requirements.³ Further, both the Listing and the Disclosure Regulations may be revised in significant ways prior to adoption as final rules. A transition period of 90 days following publication of the final regulations would permit advisors to tailor their compliance systems to the final rules.

B. Comments on the Disclosure Regulations.

The Disclosure Regulations generally require all taxpayers to disclose direct or indirect participation in any reportable transaction. A "reportable transaction" is defined as a "transaction" that falls within any one of the following six categories: (i) listed transactions, (ii) confidential transactions, (iii) transactions with contractual protection, (iv) loss transactions, (v) transactions with significant book-tax differences, and (vi) transactions involving a brief asset holding period. The term "transaction" is defined to include all of the factual elements relevant to the expected tax treatment of any investment, entity, plan or arrangement, and includes any series of steps carried out as part of a plan, and any series of substantially similar transactions entered into in the same taxable year. Our comments on these disclosure rules are set out below.

1. Loss Transactions (Temp. Treas. Reg. § 1.6011-4T(b)(5)).

A loss transaction is generally defined as any transaction resulting in, or that is reasonably expected to result in, a taxpayer claiming a loss under Code Section 165 in excess of certain specified dollar thresholds.⁴ The amount of any Section 165 loss is adjusted for any salvage value and insurance or other compensation received. However, any offsetting gains or other income limitations are not taken into account in applying the dollar thresholds, *i.e.*, the amount of any Section 165 loss is generally determined on a gross basis.

a. Proposed Exception for Public Securities Transactions.

³ In contrast, the Disclosure Regulations do not require affirmative action until the time that a taxpayer files its tax return, which may be more than one year after the effective date of the regulations.

⁴ For corporate taxpayers, these thresholds are \$10 million in any single taxable year or \$20 million in any combination of taxable years. For partnerships and S corporations, the thresholds are \$5 million in any single taxable year and \$10 million in any combination of taxable years (whether or not any losses flow through to one or more partners or shareholders). For individuals and trusts, the thresholds are \$2 million and \$4 million, respectively, unless the loss is a Code Section 988 foreign currency loss, in which case it need only be greater than \$50,000 in any single taxable year.

The preamble to the Disclosure Regulations indicates that the IRS and the Treasury Department are considering an additional exception that would exclude from the loss transactions category any sale of securities on an established securities market (within the meaning of Treas. Regs. § 1.7704-1(b)), but only if the amount of basis used in computing the taxpayer's loss is equal to the amount of cash paid by the taxpayer to acquire the securities. An established securities market would include for this purpose U.S. national, regional and local securities exchanges, certain foreign exchanges, and certain interdealer quotation systems (such as NASDAQ).⁵

We urge the IRS and the Treasury Department to adopt this proposed exception. While it is possible that a potentially abusive transaction could include as one element a sale of securities on an established securities market (at a loss), we believe that any such transaction is likely to have other features that would cause it to fall within one of the other categories of reportable transactions. Therefore, we do not believe that adoption of the proposed exception will significantly reduce the number of abusive transactions that are reportable under the Disclosure Regulations. Without this exception, however, a large volume of routine, non-abusive transactions will become reportable – particularly if the term “transaction” is interpreted for this purpose to require aggregation of all of a taxpayer's securities sales during the taxable year (on the grounds that they are “substantially similar” transactions) for purposes of applying the dollar thresholds.

We would ask, however, that the IRS and Treasury consider certain modifications to the proposed requirement that a taxpayer's basis in the securities sold be equal to the amount of cash paid to acquire the securities. As proposed, this requirement would require disclosure in some significant situations that could be expected to provide little (if any) benefit to the government. For example, disclosure would be required with respect to public sales of (i) stock that has a carryover basis because it was received by the taxpayer in a tax-free reorganization involving a publicly traded corporation or (ii) securities that have a stepped-up fair market value basis because they were received by the taxpayer as a bequest upon the death of the previous holder. We suggest that the IRS and Treasury consider exempting these categories of public securities sales from disclosure, even though the cash basis requirement is not met.

⁵ We note that the preamble to the Disclosure Regulations does not provide a definition of “securities” in describing this potential exception. We would suggest that the term be defined by reference to subparagraphs (A) through (E) of Code Section 475(c)(2). Although such a definition would appear broad on its face, it would be limited as a practical matter by the fact that a transaction in a security would only be eligible for the exception to the extent that such security was traded on an established securities market. Thus, for example, a relatively limited variety of derivative financial instruments would be included.

In addition, we note that a cash basis requirement presents difficult implementation issues, and a broker-dealer seeking to rely on this exception for purposes of the list maintenance requirements in the Listing Regulations may not know the taxpayer's basis in securities that are sold through the broker-dealer. This might be the case, for example, if a customer opened a new account with a broker-dealer and transferred into the account a portfolio of securities that the customer had previously acquired and held through another financial institution. We recommend, therefore, that a broker-dealer or other material advisor seeking to determine the application of this exception for purposes of the Listing Regulations be permitted to assume that a taxpayer's basis in securities sold on an established securities market is equal to the amount of cash paid by the taxpayer to acquire the securities (and that any other factual elements of an expanded exception are met), unless such broker-dealer or other advisor has actual knowledge to the contrary.

b. Hedged Positions.

As noted above, Temp. Treas. Regs. § 1.6011-4T(b)(5)(ii) provides that the existence and amount of a Section 165 loss arising from a transaction is determined without taking into account any offsetting gains or other income from the transaction. Under this rule, a hedged position in securities could be treated as reportable if one leg of the position produces a sufficiently large loss, even though the taxpayer realizes a net gain (or a net loss that is below the dollar thresholds) from the position as a whole.

We believe that this feature of the loss transactions category is likely to produce a substantial amount of unnecessary disclosure by financial institutions and other taxpayers that are active in the securities markets. We recommend, therefore, that the IRS and Treasury Department consider providing a limited exception for hedged positions. Under such an exception, taxpayers would be permitted to take into account offsetting income and gains from a hedged position in determining the size of any loss from the position, but only to the extent that such income or gain is recognized either (i) during the same taxable year as the loss or (ii) in a year preceding the year in which the loss is recognized. The exception would further be limited to hedged positions that are identified pursuant to a statutory or regulatory provision, such as Section 475(b)(1)(C), Section 1092, Section 1256(e), Treas. Reg. § 1.1221-2, and the integrated transaction rules of Treas. Reg. §§ 1.988-5 and 1.1275-6. These types of hedged positions are already afforded integrated treatment for other purposes under the Code, and focusing solely on the loss leg of such positions for disclosure purposes is inconsistent with the intent of this integrated treatment, *i.e.*, to treat all legs together as a single transaction for purposes of measuring taxable income or loss. These positions, moreover, are subject to well-established identification rules that facilitate discovery and examination by IRS auditors.

c. Section 475 Mark-to-Market Rules.

The preamble to the Disclosure Regulations indicates that the IRS and Treasury Department are considering an additional exception to the loss transactions

category for losses arising from the marking to market of securities by a dealer in securities under Section 475(a). We strongly support adoption of such an exception, but we believe that it should also cover losses arising from marking to market under Section 475(e) (by dealers in commodities) or Section 475(f) (by traders in securities or commodities).⁶ We note that the category for transactions with a significant book-tax difference (discussed below) already includes such an exception,⁷ presumably on the grounds that the mere fact of compliance with the Section 475 requirements (or the making of an election to mark to market under Section 475) should not result in a reporting obligation. The same rationale applies in this context. Marking to market can just as easily produce losses as gains. As a result, if marking to market under Section 475 is considered a “transaction” for purposes of the loss transactions category, securities firms will be required to produce large volumes of disclosure on routine business operations.

d. Determining Expected Gain or Loss.

Under the Disclosure Regulations, a transaction is required to be disclosed if there is a “reasonable expectation” of a loss in excess of the dollar thresholds. The regulations do not, however, provide any guidance on the manner in which expected loss (or gain) is to be determined for this purpose. In particular, it is not clear how the regulations would apply to a transaction that presented, for example, an 80% chance of producing a loss of \$11 million for a corporate taxpayer and a 20% chance of producing a gain of \$90 million. There would seem to be at least two alternatives. Under the first alternative, disclosure would be required because the transaction had a greater than 50% chance of producing a loss greater than \$10 million. Under the second alternative, disclosure would not be required because the transaction would be expected (taking into account the probabilities of gain and loss) to produce a gain of \$9.2 million (\$90 million x 0.2 minus \$11 million x 0.8). We believe the latter approach is more consistent with the analyses used by financial institutions and many taxpayers in determining whether or not to enter into a transaction. Therefore, we recommend that the Disclosure Regulations make clear that expected loss is to be determined by taking into account the relative probabilities of gain and loss from the transaction.

e. Change in Expectations.

⁶ We would also support adoption of an exception for marking to market under Section 1296(a), as also mentioned in the preamble, and under Section 1256. The mere fact of compliance with statutory mark-to-market rules should not give rise to a presumption of tax avoidance motivation, and failure to provide for these exceptions will result in a considerable amount of unnecessary disclosure.

⁷ The exception from the book-tax difference transactions category is not limited to Section 475(a), but covers broadly any marking to market under Section 475.

The Disclosure Regulations define a loss transaction to include any transaction “that is reasonably expected to result in” a taxpayer claiming a loss under Code Section 165. Presumably, this definition is intended to include any transaction for which this reasonable expectation exists at the outset. It is not clear, however, whether the regulations are also intended to give rise to a disclosure obligation during the term of a transaction if a taxpayer’s initial expectation of profit later changes to an expectation of loss (e.g., due to unanticipated market movements). In fact, expectations may fluctuate during the term of any transaction, varying from profit to loss and back again. It is not clear whether the Disclosure Regulations are intended to require that a taxpayer disclose a transaction merely because, at some point before or during the term of the transaction, a loss is expected.

We assume, however, that the loss transaction category is intended to force disclosure of transactions that a taxpayer *enters into* with the objective of generating a loss. Therefore, we recommend that the regulations be clarified to indicate that a reasonable expectation of loss must exist at the time the transaction is entered into, and that a transaction in respect of which a profit was initially expected will not subsequently become reportable merely because later circumstances change that expectation to a loss.⁸ Any other rule would amount, in effect, to a requirement that transactions be marked to market on a daily or otherwise frequent basis in order to test whether a built-in loss had arisen. Not only would this be impractical, but it would also produce a substantial amount of unnecessary disclosure.

2. Book-Tax Difference Transactions (Temp. Treas. Reg. § 1.6011-4T(b)(6)).

The Disclosure Regulations define a transaction with a significant book-tax difference generally as a transaction where the treatment for Federal income tax purposes of any item or items of the transaction differs, or is reasonably expected to differ, by more than \$10 million on a gross basis from the treatment of the item or items for book purposes in any year.

a. Marking to Market under Section 1256.

Temp. Treas. Reg. § 1.6011-4T(b)(6)(iii)(L) provides an exception from the category of transactions with a significant book-tax difference for marking to market under Section 475 or Section 1296. We note that the mark-to-market requirements of Section 1256 also often result in significant book-tax differences, and we assume that the IRS and Treasury Department did not intend to require that taxpayers report the

⁸ A taxpayer who, at the outset, secured the opportunity to make some later change in the terms of the transaction, in order to convert its expected results from a profit to a loss, would be considered to have a reasonable expectation of loss at the outset.

mere fact of compliance with Section 1256. Therefore, we recommend that a reference to Section 1256 be added to Temp. Treas. Reg. § 1.6011-4T(b)(6)(iii)(L).

b. Entities that Do Not Maintain GAAP Books.

The Disclosure Regulations do not indicate whether an entity that meets the \$100 million gross asset test but maintains only a single set of books for tax and other business purposes is required to construct U.S. GAAP books solely in order to determine whether its transactions are reportable under the regulations. For example, partnerships or other investment vehicles established to hold private investments may maintain only a single set of books that apply for both income tax and other business purposes (e.g., reporting to investors and determining entitlements to distributions). We suggest that the regulations be clarified to provide that an entity which is not required to, and does not, maintain a set of books that varies from its tax accounting books (i) is not required to construct a set of U.S. GAAP books solely for purposes of the Disclosure Regulations and (ii) is not required to report any transaction solely because it cannot establish consistent book-tax treatment.

c. Change in Expectations.

As in the case of loss transactions, we recommend that the regulations be amended to clarify that a reasonable expectation of a significant book-tax difference must exist at the outset of a transaction, and that a transaction in respect of which no or an insignificant book-tax difference was initially expected will not subsequently become reportable merely because later circumstances change that expectation.

d. Hedged Positions.

Also as in the case of loss transactions, we recommend that taxpayers be permitted to take into account offsetting income and gains from hedged positions (to the extent recognized in the same or an earlier taxable year) in determining the size of any book-tax difference. This exception would be subject to the same conditions as described above in connection with our proposed exception to the loss transactions category, *i.e.*, income or gain would have to be recognized in the same taxable year as, or in a taxable year preceding, recognition of the loss and the hedged positions would have to be identified pursuant to a statutory or regulatory provision.

e. Dividends Received Deduction.

We would appreciate clarification that the exception provided in Temp. Treas. Reg. § 1.6011-4T(b)(6)(iii)(J) for “dividends” is meant to apply to book-tax differences that are attributable to the dividends received deduction available under Code Sections 243 through 247.

3. Confidential Transactions (Temp. Treas. Reg. § 1.6011-4T(b)(3)).

A confidential transaction is defined as a transaction that is offered under conditions of confidentiality. A transaction is presumed not to be offered under conditions of confidentiality if every person who makes or provides an oral or written statement regarding the potential tax consequences of the transaction (or for whose benefit such a statement is made or provided) provides express written authorization permitting the taxpayer (and its employees, representatives and agents) to disclose to any and all persons, without limitation of any kind, the structure and tax aspects of the transaction and all materials of any kind (including opinions or other tax analyses) that are provided to that taxpayer relating to such structure and tax aspects. This written authorization to disclose must be effective without limitation “from the commencement of discussions”.

a. Timing of Written Disclosure Authorization.

We note that it may be difficult in particular circumstances to know precisely when discussions have “commenced”. For example, where discussions are undertaken between large institutions, multiple individuals from each institution may be involved and there may be a number of separate communications among different representatives of each institution. We suggest, therefore, that it would be useful to clarify that the disclosure authorization may be provided in writing within a reasonable period of time after the beginning of the discussions, although it must state when provided that it is effective as of the time of the first communication between the parties.

b. Exclusivity Arrangements.

We request that clarification be provided to the effect that a transaction that is subject to an exclusivity arrangement will not be considered a confidential transaction as long as express written disclosure authorization is provided to the taxpayer. This would be consistent with the view of the IRS and Treasury Department expressed in the preamble to the version of Temp. Treas. Reg. § 1.6011-4T issued on August 16, 2000 as T.D. 8896.

c. Foreign, State and Local Taxes.

We request that the regulations be clarified to provide that the “tax aspects” of the transaction as to which confidentiality is relevant are the U.S. federal tax aspects. Thus, for example, the fact that a taxpayer was subject to conditions of confidentiality solely with respect to a foreign, state or local tax aspect of a transaction would not cause the transaction to be treated as reportable.

d. Confidentiality Only with Respect to Structure.

We suggest that the IRS and Treasury Department consider further whether a transaction should be treated as reportable where it is offered under conditions of confidentiality that apply only to disclosure of the transaction structure, and not with respect to the tax aspects. This might be the case, for example, where a

transaction is structured in a particular manner in order to achieve a particular non-tax-related business objective, but has no unusual or questionable tax aspects. In such a case, the existence of confidentiality restrictions is not a meaningful indicator of potential for tax abuse, and it is not clear that disclosure of the transaction would provide any significant benefit to the IRS.

e. Application of Safe Harbor for Purposes of Listing Regulations.

While we agree that it is appropriate for purposes of the Disclosure Regulations to require that every person who makes a statement to the taxpayer regarding the tax consequences of a transaction provide express written disclosure authorization in order to avoid confidential transaction treatment, we do not believe that this standard is manageable for purposes of the Listing Regulations. Accordingly, we recommend that the nonconfidentiality exception be applied for purposes of the Listing Regulations on an advisor-by-advisor basis. In other words, if a particular material advisor has provided a taxpayer with an express written authorization to disclose a transaction, that advisor should be permitted to rely upon the nonconfidentiality exception for purposes of the list maintenance rules – whether or not any other material advisor to the taxpayer has also provided such an authorization. In its current form, the exception would appear to require, for purposes of the Listing Regulations, that a material advisor ask each transaction participant (including participants to whom the advisor has not itself provided advice) whether any other person has made a statement to that participant as to the tax consequences of the transaction and, if so, whether a disclosure authorization has been obtained from that person. We believe that such a requirement would be impractical in the context of large, multi-party transactions.

4. Transactions Involving Contractual Protection (Temp. Treas. Reg. § 1.6011-4T(b)(4)).

A transaction with contractual protection is defined as a transaction for which the taxpayer has obtained or been provided with contractual protection against the possibility that part or all of the intended tax consequences from the transaction will not be sustained. Such contractual protection includes rescission rights, the right to full or partial refund of fees, fees that are contingent on tax benefits, or a tax indemnity or similar agreement.

a. ISDA and Other Standard Financial Transaction Documentation.

Under a literal reading of Temp. Treas. Reg. § 1.6011-4T(b)(4), swaps, securities repurchase and securities lending transactions and other routine financial transactions executed pursuant to industry-standard form documentation could be considered “transactions with contractual protection”, because this documentation normally provides contractual protection against the unexpected imposition of

withholding or other taxes (in the form of gross-up and termination provisions).⁹ Clearly, however, the existence of this type of contractual protection in this context is not indicative of a tax avoidance motivation. Major financial institutions enter into these transactions in large volumes as part of their day-to-day business operations for reasons entirely unrelated to tax, and the tax gross-up and termination provisions exist primarily to protect against unanticipated changes in law. For a large financial institution, providing tax shelter disclosure with respect to every one of these routine transactions would entail substantial compliance costs,¹⁰ while providing only limited benefits to the IRS.

The Disclosure Regulations already contain an exception for analogous gross-up and redemption provisions in the terms of debt instruments.¹¹ We recommend

⁹ Virtually all notional principal contract business conducted by financial institutions and financial intermediaries is documented on standard forms promulgated by the International Swap Dealers Association, Inc. ("ISDA"). This standard documentation provides for a gross-up in respect of certain withholding taxes on scheduled payments and also treats as a "termination event" the unanticipated imposition of withholding taxes (whether or not subject to a gross-up) as a result of a court decision, another act of a taxing authority, or a change in law. Upon the occurrence of a termination event, the affected party may terminate the transaction prior to its scheduled termination date (unless the termination event can be avoided by transferring its position to another office or affiliate). Upon early termination, the transaction is normally marked to market and a settlement payment made to (by) the party in the gain (loss) position. See 1992 ISDA Master Agreement (Multicurrency – Cross Border), § 5(b)(ii). Industry-standard form documentation for other types of financial transactions, such as securities loans and securities repurchase transactions, contains analogous provisions. See, e.g., the standard form documentation for securities repurchase transactions promulgated by The Bond Market Association ("TBMA") and the International Securities Market Association ("ISMA"), TBMA/ISMA Global Master Repurchase Agreement, § 11 (2000 version).

¹⁰ Although it appears that substantially similar transactions can be aggregated for purposes of this disclosure, it is not clear whether interest rate swaps would be considered substantially similar to equity swaps, or even whether a fixed-to-floating swap is substantially similar to a basis swap for these purposes. If not, separate forms could be required for every transaction or every type of transaction.

¹¹ Under this exception, a transaction is not considered to have contractual protection solely because the issuer of a debt instrument agrees to pay additional interest to compensate the holder of such debt instrument for withholding tax imposed on interest paid on the debt instrument, or because the requirement to pay such additional interest entitles the issuer to redeem the debt instrument.

that this exception be expanded to cover notional principal contracts, securities loans, securities repurchase and other financial transactions entered into pursuant to industry-standard documentation that provides contractual protection (including gross-up and termination provisions) against the imposition of withholding taxes with respect to scheduled payments as a result of a change in law or the action of a taxing authority or court subsequent to the date on which the transaction was entered into. These contractual provisions have precisely the same purpose with respect to these other financial transactions as do the gross-up and redemption provisions covered by the existing exception for debt instruments.

b. Preferred Stock.

Similarly, we note that it is common for the terms of preferred stock to provide for an adjustment to the dividend rate, or a redemption right, in the event that either (i) the Code is amended to reduce or eliminate the dividends received deduction or (ii) the issuer does not have sufficient earnings and profits to ensure dividend treatment of distributions. This type of contractual protection is intended merely to preserve the investor's expected return, and is not indicative of any potential tax abuse. We recommend therefore that an exception be provided for this type of limited tax indemnification.

c. Indemnification against Breach of Contractual Duty.

We suggest that the regulations clarify that indemnification against an obligation to pay U.S. federal income tax that arises as a result of a breach of a contractual duty to take or refrain from taking certain specified actions is not a type of contractual protection that would require disclosure. For example, it is common for the manager of an investment vehicle to indemnify foreign investors in the event that actions taken by the manager or the vehicle cause the investors to be treated as engaged in a U.S. trade or business.

d. Foreign, State and Local Taxes.

Finally, as currently drafted, the category of transactions with contractual protection seems to include transactions with contractual protection against state, local or foreign taxes – even where no such protection is provided against U.S. federal taxes. U.S. taxpayers entering into ordinary business transactions with foreign counterparties often seek protection against the unanticipated imposition of foreign taxes, either because they are less able to evaluate foreign tax consequences than U.S. tax consequences or because they fear a change in law. Similarly, taxpayers based in one state or local jurisdiction may seek contractual protection against taxes levied by another state or local jurisdiction if a counterparty is located in that other jurisdiction and the taxpayer is not familiar with its tax laws. We do not believe that the IRS should have any particular interest in receiving disclosure of such transactions, when no other indicator of a potentially abusive transaction is present. Therefore, we recommend that the Disclosure Regulations be modified to clarify that the category of transactions with

contractual protection refers only to transactions in which protection is provided with respect to U.S. federal taxes.

5. Transactions Involving a Brief Holding Period (Temp. Treas. Reg. § 1.6011-4T(b)(7)).

A transaction involving a brief asset holding period is a transaction resulting in, or reasonably expected to result in, a tax credit exceeding \$250,000 (including a foreign tax credit) if the underlying asset giving rise to the credit is held by the taxpayer generally for less than 45 days. In determining the taxpayer's holding period for this purpose, the principles of Section 246(c)(3) and (c)(4) of the Code apply.

a. Foreign Tax Credits Allowed under Code Section 901(k)(4).

As drafted, this category of transactions would include a claim of a foreign tax credit made, in accordance with Code Section 901(k)(4), by a securities dealer doing business in a foreign country for a "qualified tax" imposed by a second foreign country with respect to a dividend paid on stock that is held by the dealer in the active conduct of its business for a period of less than 45 days.¹² The Section 901(k)(4) exception is designed to apply only with respect to credits claimed in respect of dividends paid on foreign securities held in inventory. Large multinational securities firms receive a substantial volume of such dividends and thus may claim a significant number of credits in the circumstances described in Section 901(k)(4). In light of the fact, however, that these credits are specifically allowable under Section 901(k)(4), we recommend that an exception be provided for a claim of a foreign tax credit where the conditions of Section 901(k)(4) are met with respect to such claim.¹³

b. Hedged Loans.

Financial institutions that make loans and other extensions of credit as part of the ordinary course of business typically hedge interest rate, currency or credit

¹² As a technical matter, the Section 901(k)(4) exception is applicable only to the extent the taxpayer's holding period is 15 days or less, because the credit claim is not otherwise restricted by Section 901(k)(1). Under the Disclosure Regulations, however, disclosure would be required even where the conditions of Section 901(k)(4) are met and the stock is held for a period of between 16 and 45 days.

¹³ This could be done by adding an exception for "the claim of a foreign tax credit for foreign withholding tax imposed on a dividend paid with respect to stock held by the taxpayer for less than 45 days, to the extent that the requirements of Section 901(k)(4) of the Code are met with respect to such claim." In other words, as long as the conditions of Section 901(k)(4) are met, the taxpayer's holding period for the stock should be irrelevant.

risk associated with those loans by entering into derivative transactions. Although these hedging transactions would have the effect of shortening the lender's holding period for the loan under the principles of Section 246(c)(3) and (c)(4), the lender's ability to claim a foreign tax credit for any withholding taxes imposed on interest paid by the borrower is not affected because Section 901(k) does not apply. Where such loans are made in the ordinary course of business, we do not believe that disclosure should be required. The loans are ordinary course transactions, and there is no abusive intent associated with either the hedging transaction or the claim of a foreign tax credit for withholding taxes on interest. We suggest, therefore, that an exception be provided for loans or other extensions of credit made by a financial institution in the ordinary course of business to the extent that the lender's holding period for the loan is reduced by a hedging transaction identified under Treas. Regs. § 1.1221-2.

6. Securitizations.

We are concerned that the Disclosure Regulations, in their current form, will result in a disclosure requirement with respect to many routine financial asset securitization transactions, because these transactions typically result in a book-tax difference. Such a difference may arise because the transaction is treated as a sale for book purposes but as a financing for tax purposes, or vice versa. Alternatively, it can arise where a noneconomic residual interest produces a "phantom loss" for tax purposes that is not taken into account for book purposes. We recognize that it would be difficult to craft a broad exception for securitization transactions, given the wide variety in the types of assets that may be securitized and in the forms that these transactions may take.¹⁴ Nonetheless, we believe that it would be helpful for the Disclosure Regulations to address certain specific issues that arise in this context.

a. Treatment of REMICs.

We recommend that additional exceptions be provided from both the loss transaction and the book-tax difference transaction categories for the "phantom" income and losses arising in mortgage securitization transactions for which real estate mortgage investment conduit ("REMIC") elections are made.¹⁵ Pursuant to Section 860D, each REMIC is required to issue a class of interests designated as residual interests. Many REMIC residual interests have the potential, and are generally expected to, produce "phantom" income in the early years of the REMIC and then produce offsetting "phantom" losses as the mortgage collateral pays off.¹⁶ This

¹⁴ For a comprehensive description and discussion of securitization transactions, see J. Peaslee and D. Nirenberg, Federal Income Taxation of Securitization Transactions (3rd. ed.), 2001.

¹⁵ The taxation of REMICs is governed by Code Sections 860A through 860G.

¹⁶ In such transactions, REMIC residuals are expected to produce phantom income and phantom losses because the weighted average yield on the REMIC's
(continued ...)

“phantom” income and loss results in a book-tax difference and an expectation of a tax loss, whether or not the residual interest is retained.¹⁷

Thus, a literal reading of the Disclosure Regulations would seem to require disclosure of virtually all REMIC transactions by the investors in the residual interests (and listing by the underwriters and issuers and their respective counsel). Even if the residual interest in any particular REMIC is not expected to produce a loss or a book-tax difference that exceeds the dollar thresholds, the application of these thresholds to “any series of substantially similar transactions entered into in the same taxable year”¹⁸ could result in a disclosure requirement for investors involved in multiple REMIC transactions (or, likewise, a listing requirement for financial institutions and advisors involved in multiple transactions). We do not believe that the IRS and Treasury intended to require such broad disclosure with respect to REMIC transactions.

b. FASIT Transactions.

Similar issues can arise in connection with the ownership interest in a financial asset securitization investment trust. Specifically, the holder of the ownership interest may have taxable income or loss from the interest that varies from its income or loss for book purposes, and the holder may have an expectation of loss due to income inclusion requirements or basis adjustments. We recommend, therefore, that the IRS and Treasury consider an exception from both the loss transaction and the book-tax difference transaction categories for FASIT ownership interests.

c. Excess Servicing Income.

We recommend that an exception be provided from the book-tax difference transaction category for differences attributable to excess servicing amounts. Securitization transactions frequently give rise to excess servicing amounts, i.e., the excess of such items as finance charges, return check fees, late fees, cash advance fees, overlimit fees and balance transfer fees over normal servicing fees, coupon interest and charge-offs. Under SFAS No. 125 (Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities), the present value of expected

(... continued)

outstanding regular interests is expected to increase over time as the interests with a shorter duration and higher seniority are retired with the proceeds of mortgage prepayments, while the REMIC’s yield from its assets is expected to remain constant.

¹⁷ Disposition of a REMIC residual interest after it has produced phantom income would produce a loss under Code Section 165, because the investor’s tax basis in the interest is increased by the excess income inclusion.

¹⁸ A “substantially similar transaction” includes all transactions that use the same tax strategy (e.g., a REMIC election). Temp. Treas. Reg. § 1.6011-4T(b)(1).

future excess servicing cash flows associated with securitized loans must be capitalized. For tax purposes, however, these amounts are not included in taxable income until they are actually earned, giving rise to a book-tax difference. We recommend that a book-tax difference attributable to the differing treatment of excess servicing amounts be excluded from the differences required to be taken into account in determining whether a securitization transaction produces a significant book-tax difference.

7. Duplicative Disclosure.

Finally, we suggest that the IRS and Treasury Department consider three general exceptions from the disclosure requirements that would minimize duplicative disclosure. The first would apply with respect to any transaction as to which the taxpayer had obtained a private letter ruling from the IRS. In such a case, the taxpayer has already disclosed the transaction to the IRS, and the IRS has formulated and expressed a view on the tax consequences. In that context, it would seem unnecessary to require that the taxpayer disclose again to the IRS that the transaction has taken place, even if it would otherwise fall within one of the categories of reportable transaction.

Second, we suggest that certain kinds of ordinary business transactions that may fall within the various categories of reportable transactions, but for which specific exceptions may otherwise be difficult to draft, could be excluded from reporting on the grounds that disclosure is already required under other regulatory provisions. The most obvious examples of this type of transaction would be corporate reorganization transactions governed by Sections 332, 351 or 368. In each case, taxpayers involved in such a transaction are required to attach to their returns a detailed statement providing information very similar to what Form 8886 would require.¹⁹ IRS auditors thus are put on notice that the transaction has occurred, and they are free to examine it in detail. While this notification would not ordinarily be provided in the first instance to the Office of Tax Shelter Analysis (OTSA), we suggest that the potential benefits of immediate OTSA notification are not likely to be significant by comparison to the compliance burdens arising from duplicative disclosure requirements.²⁰ Such an exception could be limited to transactions for which every element was subject to reporting under the Section 332, 351 or 368 regulations. Thus, if a corporate reorganization were only one of several elements of a larger transaction, that larger transaction would still be subject to reporting under the Disclosure Regulations

¹⁹ See Treas. Regs. §§ 1.332-6, 1.351-3, and 1.368-3.

²⁰ As an alternative, taxpayers could be permitted to file the Section 332, 351 or 368 statement with OTSA in lieu of Form 8886.

notwithstanding that a disclosure statement was filed under, for example, Treas. Regs. § 1.368-3.²¹

Finally, we recommend that the Disclosure Regulations be clarified to require disclosure of a transaction only once, even where the transaction has a reportable characteristic that recurs over a period of years. For example, a transaction may produce a significant book-tax difference both in the year of execution and in a number of subsequent years. If the transaction is disclosed in the first relevant year (and there have been no material modifications since the disclosure was filed), it should not have to be disclosed again in subsequent years.

* * * * *

Thank you for your consideration of our views. We would be pleased to discuss the foregoing comments with members of the IRS and Treasury Department staff. Please contact Patricia McClanahan, SIA's Vice President and Director for Tax Policy (202-326-5324), if we can provide you with any further information.

Sincerely,

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²¹ Other types of ordinary business transactions that may be treated as reportable transactions (e.g., due to a significant book-tax difference) and for which separate disclosure is already required include like-kind exchanges, which are reportable on Form 8824, and installment sales, which are reportable on Form 6252.