



STROOCK

SPECIAL BULLETIN

Eight Regulations the IRS Says Are “Unduly Complex,” Impose “an Undue Financial Burden on Taxpayers” or Exceed the IRS’s Statutory Authority

August 1, 2017

Responding to President Donald Trump’s Executive Order 13789,¹ which called on the Secretary of the Treasury to submit an interim report identifying any significant tax regulations issued since January 1, 2016 that (i) impose an undue financial burden on taxpayers; (ii) add undue complexity to federal tax laws; or (iii) exceed the statutory authority of the IRS, the IRS has released Notice 2017-38, which lists eight regulations that it has determined meet one or more of these criteria.² Notably, no regulations

were identified as exceeding the statutory authority of the IRS.

This **Stroock Special Bulletin** provides an overview of these eight regulations, with particular focus on three that have received widespread attention and comment.

Three Significant Regulations

Section 385 – Final and Temporary Regulations on the Treatment of Certain Interests in Corporations as Stock or Indebtedness

When the IRS released proposed regulations under Section 385³ on whether an interest in a corporation is to be treated as stock or indebtedness, the comments submitted by the public indicated considerable concern about their

the purpose of the interim report, the IRS identified only eight that met the criteria set forth by the Order.³ T.D. 9790; 81 F.R. 72858.

¹ Executive Order 13789 – Identifying and Reducing Tax Regulatory Burdens. April 21, 2017. References to Sections in this *Stroock Special Bulletin* are to sections of the Internal Revenue Code.

² Notice 2017-38– Implementation of Executive Order 13789 (Identifying and Reducing Tax Regulatory Burdens). Note that the Notice acknowledged that between the period of January 1, 2016 and April 21, 2017, 105 temporary, proposed and final regulations were issued. However, 53 of the regulations were seen as minor or technical in nature and thus generated minimal public comment. Although the remaining regulations were treated as significant for

scope and potential impact. Consequently, the final and temporary regulations released by the IRS in October 2016 were somewhat scaled back, establishing only (i) minimum documentation requirements that must be satisfied for a related party interest in a corporation to be treated as debt for federal tax purposes;⁴ and (ii) transaction rules that treat certain related party interests as stock.⁵

Despite the more limited scope of these regulations, commenters have expressed continuing concern that compliance will be overly burdensome, particularly when they are applied to ordinary course transactions. Additionally, commenters have noted the complexity associated with tracking multiple transactions through a group of companies.

Section 337(d) - Temporary Regulations on Certain Transfers of Property to Regulated Investment Companies and Real Estate Investment Trusts

At one time, a corporation could rely on the General Utilities doctrine to distribute appreciated property to shareholders without recognizing gain. The doctrine was later repealed and at present a corporation is required to recognize such gain. Section 355⁶, which has been described as a “limited exception to the repeal of the General

Utilities doctrine,” became a means for a tax-free distribution of stock to continue to take place.

Under Section 355 a corporation may distribute stock of one or more controlled corporations to its shareholders and security holders without the distributing corporation recognizing income, gain, or loss on the distribution. Through the passage of the Protecting Americans from Tax Hikes Act of 2015 (“PATH Act”), Section 355(h) was added to prevent a Section 355 distribution from occurring when the distributing corporation or controlled corporation is a REIT. Significantly, this regulation does not apply to conversion transactions.

Relying on its authority under Section 337(d)⁷, the Treasury released temporary regulations to ensure that Real Estate Investment Trusts (“REITs”) and Regulated Investment Companies (“RICs”) are not used as a means to avoid recognizing gain. In order to prevent taxpayers from engaging in transactions that could circumvent limitations enacted by the PATH Act, the temporary regulations provide that if a C Corporation engages in a conversion transaction with a REIT or RIC within a 10-year period from the date the C Corporation acquired the property, the C Corporation is required to recognize any gain from such transfer.

Although the temporary regulations contain exceptions for situations in which both the distributing and controlled corporations are REITS immediately after the date of the distribution (and for two years thereafter), and for situations in which the distributing corporation is a REIT and the controlled corporation is a taxable REIT subsidiary, commenters have expressed concern

⁴ Under the final and temporary regulations, the documentation rules were delayed and expected to apply to debt issued on or after January 1, 2018. However, the IRS released Notice 2017-36 which states that the IRS intends to amend the documentation regulations to apply only to interests issued or deemed issued on or after January 1, 2019.

⁵ Note that under the final and temporary regulations, the recharacterization rules are effective January 19, 2017, though they grandfather debt instruments issued before April 5, 2016.

⁶ 26. U.S.C. §355.

⁷ T.D. 9770; 81 F.R. 36793.

that the rules could lead to over-inclusion of gain – specifically in situations where a large corporation acquires a small corporation that engaged in a spinoff, and the large corporation subsequently makes a REIT election.

Section 2704 - Proposed Regulations Relating to Discounts on a Transfer of an Interest for Estate, Gift and Generation-Skipping Transfer Tax Purposes

Under current Section 2704(b)⁸, transfers of minority or other non-controlling interests in a closely held company should reflect discounts for lack of control and to some degree lack of marketability for gift, estate and generation-skipping tax purposes. Generally speaking, minority owners are granted investment, managerial and distribution powers, rather than management of the company, and therefore would be able to demand a discount to reflect the lack of control and marketability. In August 2016, the Treasury Department released proposed regulations⁹ that would virtually eliminate “lack of control” discounts and significantly impact “lack of marketability” discounts for family controlled entities for gift, estate and generation-skipping transfer tax purposes.¹⁰ Through a new category of restrictions known as “disregarded restrictions,” certain restrictions in an entity’s governing

documents would be disregarded for valuation purposes.¹¹

Many commenters expressed concerns that the regulations would place an undue financial burden on taxpayers by, among other things, eliminating common discounts that are helpful to promote the continuation of family businesses. The discounts, commenters noted, enable the flow of businesses to younger generations and the implementation of the new rules would further complicate this transfer.

The IRS may look to reduce the complexity of these regulations by providing further guidance on how interests are to be valued when there is a disregarded restriction. Additionally, while the proposed regulation, with respect to disregarded restrictions, calls for an effective date that is 30 days after final regulations are published in the Federal Register, some commenters have suggested a 90-day period would be more appropriate. It is also possible that the IRS will pull the regulation in its entirety.

Five Additional Regulations

- **Section 752, Temporary Regulations on Liabilities Recognized as Recourse Partnership Liabilities¹²**, addressing allocation of liabilities for the purpose of disguised sales under Section 707¹³, as well as rules to determine if a “bottom dollar payment obligation” meets the economic risk of loss needed to be classified as a recourse liability.
- **Section 987, Final Regulations on Income and Currency Gain or Loss with respect to a Section 987 Qualified Business Unit¹⁴**, providing rules for

⁸ 26 U.S.C. §2704(b).

⁹ REG-163133-02; 81 F.R. 51413.

¹⁰ For a detailed discussion on proposed regulations for Section 2704, see “New Proposed Treasury Regulations Imperil Valuation Discounts for Family Controlled Entities,” by Anita S. Rosenbloom, *Stroock Estate Planning Alert*, August 25, 2016, available at <http://www.stroock.com/publications/new-proposed-treasury-regulations-imperil-valuation-discounts-for-family-controlled-entities>.

¹¹ *Id.*

¹² T.D. 9788; 81 F.R. 69282.

¹³ 26 U.S.C. §707.

¹⁴ T.D. 9794; 81 F.R. 88806.

determining income from a branch conducted in a different currency than the branch owner's functional currency and computing foreign currency gains or losses.

- **Section 367, Final Regulations on the Treatment of Certain Transfers of Property to Foreign Corporations**¹⁵, removing the ability of taxpayers to transfer foreign goodwill and going concern value to a foreign corporation without facing immediate or future income tax.
- **Section 103, Proposed Regulations on Definition of Political Subdivision**¹⁶, expanding on the eligibility requirements for a political subdivision, for the purpose of issuing tax-exempt bonds, by imposing requirements an entity must possess in order to be characterized as such.
- **Section 7602, Final Regulations on the Participation of a Person Described in a Summons Interview**¹⁷, granting the IRS authority to allow certain persons with whom the IRS contracts for services to receive materials summoned by the IRS and participate in the interview of a summoned person.

The Treasury Department rejected requests to reexamine under the Order the dividend equivalent regulations under Section 871(m)¹⁸ and the Foreign Account Tax Compliance Act that some commentators had sought.

Conclusion

The Treasury Department is requesting comments, which are due by August 7, 2017, on whether these regulations should be rescinded or modified. Comments seeking modification of the

regulations should specify what modifications should be made to reduce burdens and complexity. The Department plans to submit a final report to the President by September 18, 2017. We will continue to monitor and provide updates on future developments. In the meantime, please feel free to contact us with any questions you may have.

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¹⁵ T.D. 9803; 81 F.R. 91012.

¹⁶ REG-129067-15; 81 F.R. 8870.

¹⁷ T.D. 9778; 81 F.R. 45409.

¹⁸ T.D. 9815; 82 F.R. 8144.

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