AMERICANS FOR TaxFairness

June 7, 2022

Submitted via the Federal eRulemaking Portal

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RE: Recommendations of Items to be Included on the 2022-2023 Priority Guidance Plan

The following recommendations have been prepared by Americans for Tax Fairness (ATF), a diverse coalition of hundreds of national and state endorsing organizations united in support of a fair and transparent tax system that benefits all Americans. Numerous partner organizations and academic advisors helped prepare these recommendations.

Because this is a comment responding to the call for submissions on the Priority Guidance Plan, the focus is on recommendations for "regulations, revenue rulings, revenue procedures, notices, and other published administrative guidance." However, please note that ATF has separately detailed our recommendations for other types of administrative actions that would raise more revenue, create a fairer tax system and promote racial equity.

Sincerely,

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RECOMMENDATIONS TO THE TREASURY DEPARTMENT AND IRS ON REGULATIONS AND GUIDANCE TO RAISE REVENUES AND PROMOTE TAX FAIRNESS AND TAXPAYER TRUST

June 7, 2022

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INTRODUCTION

As the Biden administration pursues a historic opportunity in Congress to rewrite parts of the tax code to help finance long-term investments that will build America back better, Americans for Tax Fairness also urges the administration to aggressively use executive actions—from new regulations to revenue rulings to other published administrative guidance—to increase the effectiveness and fairness of the code, promote racial equity, restore taxpayer trust and raise much-needed revenue.

These goals would be advanced by the proposed executive actions in this report that are within the scope of Treasury's authority. Each of these recommendations is made because it is good tax policy and could likely withstand a legal challenge as an executive action.

Among the most useful regulatory steps the administration could take are reversals of abusive rules adopted by the Trump administration when it implemented the Tax Cuts and Jobs Act (TCJA) of 2017. Quick success can also be accomplished with proposed regulatory reforms from earlier administrations that have already been drafted—and in some cases have even been through the vetting process—and only await finalization.

Among the regulations the Treasury Department should reverse are those that allow wealthy individuals to exploit tax breaks for pass-through businesses, enable wealthy investors to use Opportunity Zones as tax shelters without regard for community benefit, and expand tax breaks for multinational corporations that shift profits offshore.

Numerous regulations could be adopted that would close estate and gift tax loopholes, which are only benefiting the very wealthy and their heirs.

Other international corporate tax reforms are proposed that are new initiatives beyond rewriting flawed TCJA regulations. Several reforms to tax breaks benefiting the financial industry are also proposed, most importantly reforms to the treatment of carried interest and requiring derivatives to be marked to market.

Finally, in other contexts, we have emphasized that tax policy and administration have substantial impacts on racial and gender disparities and have recommended that Treasury and IRS build its capacity to use tax and other data to analyze those issues. We are encouraged by the Treasury's commitment to advance equity analysis. Equity considerations must inform not only tax policymaking, but also the prioritization of regulations and other guidance. Therefore, given the vast disparities of income and wealth, Treasury and IRS should prioritize rules and guidance that would end abuses and close loopholes exploited by wealthy individuals and large businesses.

A. CLOSE INDIVIDUAL & BUSINESS TAX LOOPHOLES

1. Close estate and gift tax loopholes by reforming grantor trust rules to prevent avoidance of income and transfer taxes (Regulations, Other Executive Action), High Priority

Ultra-wealthy families avoid estate, gift and generation-skipping taxes through manipulation of trusts and by undervaluing assets donated to such trusts (or transferred outright to family members). They have been able to pass great fortunes down the generations without paying the taxes intended to curb economic dynasties and raise revenue for public services.

Over the past several decades, advisers to high-net-worth clients have developed a number of strategies that have facilitated the transfer of billions of dollars of wealth across generations without payment of estate or gift taxes. In many cases, taxpayers can execute these wealth-transfer strategies while retaining the income tax benefit of stepped-up basis at death. These strategies typically rely on some or all of the following elements:

- **Intentionally defective grantor trusts (IDGTs)**, which are excluded from the taxpayer's gross estate for transfer tax purposes but are designed to have a "defect" that results in their treatment as grantor trusts for income tax purposes;
- **Grantor retained annuity trusts (GRATs)**, which allow taxpayers to avoid estate and gift taxation of future asset appreciation over a low hurdle rate; and
- **Revenue Ruling 85-13**, which allows for income tax-free transactions between a trust and its grantor.

In addition, some taxpayers have taken the dubious position that stepped-up basis applies even to assets in an IDGT, though the IRS has rejected this position in informal guidance (see Chief Counsel Advice 200937028).

The avoidance of both income and transfer taxes through IDGTs and GRATs is indefensible from a policy perspective and inconsistent with congressional intent. To combat it, Treasury and the IRS should take the following steps:

a. **Rescind Revenue Ruling 85-13 and apply *Rothstein*.** In *Rothstein v. United States*, 735 F.2d 704 (2d Cir. 1984), the Second Circuit—in an opinion by the esteemed Judge Henry Friendly—held that a transaction between an IDGT and its grantor is a taxable event for income tax purposes. Under *Rothstein*, existing strategies for the avoidance of income and transfer taxes through the use of IDGTs and GRATs would become much less attractive. The payment of the annuity by a GRAT with appreciated assets would generate additional capital gains tax liability and the swap of cash or notes for an IDGT's appreciated assets would generate further capital gains tax liability. Note that under Code section 267, taxpayers still would not be able to generate losses through grantor-trust transactions—only gains.

In Revenue Ruling 85-13, the IRS (then under the Reagan administration) chose not to follow *Rothstein* and instead to treat transactions between a taxpayer and her grantor trusts as tax-free. This decision has had deleterious effects on tax administration for three-and-a-half decades. The IRS should rescind Revenue Ruling 85-13 immediately and then promulgate regulations adopting the holding of *Rothstein*.

b. Rescind Revenue Ruling 2004-64. When a taxpayer makes an outright gift of income-generating assets, liability for income taxes arising from those assets shifts to the recipient. By contrast, when a taxpayer transfers income-generating assets to a grantor trust, the taxpayer remains liable for income tax on income generated by trust assets. In a 1994 private letter ruling (PLR 9444033), the IRS stated that a grantor's payment of income tax with respect to income generated by trust assets would constitute an additional gift to trust beneficiaries. However, the IRS later modified that letter ruling and ultimately reversed its position, holding in Revenue Ruling 2004-64 that a grantor's payment of income tax attributable to trust income does *not* constitute an additional gift.

Revenue Ruling 2004-64 supersizes the already substantial transfer tax advantages of IDGTs. It effectively allows taxpayers to make additional annual gifts to their children or other beneficiaries without triggering additional gift tax liability. The IRS should rescind Revenue Ruling 2004-64, and the Treasury should promulgate regulations adopting the position initially stated in Private Letter Ruling 9444033.

c. Confirm via regulation or revenue ruling that assets in an IDGT do not receive stepped-up basis. The general view among tax scholars and practitioners is that assets in an IDGT that are outside a decedent's gross estate do not receive stepped-up basis. The IRS has confirmed this view in informal guidance (see Chief Counsel Advice 200937028), but a number of practitioners continue to advise clients that trustees or beneficiaries can claim stepped-up basis for assets in an IDGT at the time of a grantor's death. The IRS should issue a revenue ruling confirming the consensus view, which will trigger penalties under Code section 6662 for taxpayers who continue to claim stepped-up basis for IDGT assets. The IRS also should issue a notice attaching listed-transaction status to any sale or exchange in which a taxpayer claims stepped-up basis for assets in an IDGT at the time of the grantor's death.

d. Issue regulations applying step transaction treatment to IDGT formations followed by sales of existing life insurance policies. A common strategy to avoid the application of Section 2035 to transfers of life insurance policies is for a grantor to make a modest cash gift to an IDGT, followed very shortly thereafter by a sale of an existing life insurance policy, where the trust uses the prior gift as the down payment, together with a note for the balance of the purchase price. Currently, there are no regulations addressing the conditions under which those two steps must be collapsed into one transaction. As a result, taxpayers often treat nearly simultaneous steps as separate transactions, thereby allowing the transfer of life insurance policies shortly before the death of the grantor to avoid the reach of Sections 2035 and 2042. Treasury should promulgate regulations establishing a presumption that the gift of property to a trust followed within one year by the trust's use of the property to purchase additional property from the grantor are parts of the same transaction.

e. Issue regulations to limit the use of zeroed-out GRATs.

Tax avoidance planners have developed a strategy, based on the holding in *Walton v. Commissioner*, 115 TC 589 (2000), in which the value of the retained annuity in a GRAT is made equal or nearly equal to the value of the assets transferred to the GRAT. This gives rise to tax consequences that are divorced from economic reality, as they assign a zero value for gift tax purposes to gifts that have economic value. The Treasury should promulgate regulations to limit this strategy.

- **Apply regulation § 25.2511-1 and *Estate of Lang* to failed GRATs.** Treasury Regulation section 25.2511-1(a) establishes that the gift tax applies to direct and indirect transfers, including "the forgiving of a debt." Interpreting that provision, the Ninth Circuit held in *Estate of Lang v. Commissioner*, 613 F.2d 770 (9th Cir. 1980), that a taxable transfer occurred under when a taxpayer allowed the statute of limitations to run on the collection of an intra-family loan. According to *Lang*, the expiry of the statute of limitations constituted a taxable transfer because it was—in substance—equivalent to the forgiving of an intra-family debt.

  The logic of *Lang* applies with equal force to the failure of a GRAT. A GRAT gives the grantor the right to receive fixed amounts on an annual or more frequent basis. The failure of a GRAT extinguishes that right. Although the release of the grantor's right occurs through the termination of a trust rather than the expiry of the statute of limitations, the effect is the same: the grantor is not paid what she is owed unless the beneficiaries of the trust gratuitously decide to reimburse her.

  So far, the IRS has not applied the logic of *Lang* to failed GRATs. As a result, zeroed-out GRATs continue to offer high-net-worth taxpayers a heads-I-win, tails-we-tie wealth transfer opportunity. To align transfer tax results with economic substance, the IRS should announce via revenue ruling or revenue procedure that the termination of a trust without full payment of amounts owed to the grantor will constitute a taxable transfer by the grantor of the unpaid amounts. The Treasury should then codify this position via regulation. Once this has happened, zeroed-out GRATs will carry a potentially significant gift tax downside and will be a much less attractive tax avoidance strategy.[1]

- **Require GRATs to have a minimum value of 25% of assets contributed.** In its fiscal year 2016 budget, the Obama-Biden administration proposed an amendment to section 2702 under which the remainder interest in a GRAT at the time of creation would need to have a minimum value equal to the greater of 25% of the value of the assets contributed to the GRAT or $500,000. The first piece of this proposal—the 25% minimum—could be accomplished via regulation. Code section 2702(b)(1) requires that a qualified annuity interest must consist of "the right to receive *fixed* amounts payable not less frequently than annually." When the remainder interest in a GRAT at the time of creation is zero or close to zero, the grantor's right to receive fixed payments is chimerical because any diminution in the value of GRAT assets will reduce the amount of those payments. Treasury should promulgate regulations interpreting the language of section 2702(b)(1) to require a remainder interest of at least 25% at the time of a GRAT's creation.[2]

f. **Reissue and finalize family limited partnership regulations.** In August 2016, the Obama-Biden administration issued proposed regulations restricting the abuse of family limited partnerships (FLPs) for transfer tax purposes. The proposed regulations reflected a years-long effort to craft sensible rules limiting valuation discounts that are delinked from economic substance. Rather than building on the Obama-Biden administration's careful work, the Trump administration withdrew the proposed regulations and took no subsequent action to limit FLP abuse. The Treasury should reissue and finalize these regulations.

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[1] A more aggressive approach would be to apply the logic of *Estate of Atkinson*, 309 F.3d 1290 (11th Cir. 2002), to GRATs. In *Atkinson*, the Eleventh Circuit held that the failure of an estate to comply with tax regulations regarding annual disbursements from a charitable remainder annuity trust resulted in the complete denial of a charitable deduction. The same logic would suggest that the failure of a GRAT to comply with regulations regarding annual or more frequent annuity payments, see Reg. § 25.2702-3(b)(4), should result in the complete denial of qualified-interest status under section 2702. The upshot would be that the failure of a GRAT would result in a taxable gift not only of unpaid annuity amounts, but of the entire value of the property transferred to the GRAT.

Estate and gift tax practitioners acknowledge that the application of *Atkinson* would be devastating to the GRAT strategy. As between the more aggressive approach of applying *Atkinson* and the more moderate approach of applying *Lang*, Treasury and the IRS should choose based on a weighing of litigation risk. *Atkinson* has not been followed by other courts of appeals, whereas the logic of *Lang* is widely accepted. Either approach would constitute a significant improvement over the status quo.

[2] A more moderate approach would be to limit the use of the section 7520 valuation tables to GRATs which have a remainder interest at the time of creation equal to or greater than 25 percent of the amount contributed. See I.R.C. § 7520(b) (section 7520 valuation tables shall not apply where specified by regulation). Taxpayers establishing zeroed-out or close-to-zeroed-out GRATs would then be required to obtain an appraisal of the fair market value of the remainder interest.

Revenue effects. In 2012, Treasury estimated that a legislative change to FLP rules similar to the 2016 proposed regulations would generate $18 billion in revenue over a ten-year window. In 2016, Treasury estimated that changes to GRAT and grantor trust rules more modest than those proposed here would generate $19 billion in revenue over a ten-year window. In light of inflation, GDP growth, and the greater scope of the GRAT and grantor trust changes, it is likely that the changes proposed here would raise—in combination—more than $50 billion over the FY 2022-2031 period.

2. **Limit abuse of the TCJA's pass-through deduction (Regulations), High Priority**
The vast majority of American businesses are so-called "pass-through" entities: sole proprietorships, partnerships, and S corporations. These entities do not pay the corporate income tax. Instead, profits and losses are passed through to the individuals who own the business, and they pay any tax due on their personal returns at individual rates. Pass-through businesses run the gamut from corner groceries and independent web designers to billion-dollar real estate developers and high-priced law firms, even companies in various industries as big as Fortune 500 corporations. But even though the business form is broadly shared among different-sized companies, the income flowing to them is not: half of all pass-through income goes to the wealthiest 1% of tax filers.

Under the TCJA, owners of certain pass-through businesses are allowed with several restrictions, to exclude up to 20% of their business income from taxation. It has been projected that three-fifths of the value of this tax break, supposedly targeted at "small businesses," will go to the richest 1% of tax filers by 2024. Initial data from the JCT shows that two-thirds (66%) of this tax break is accruing to those with household income above $315,000 for joint filers.

Moreover, the final regulations issued by the Trump Administration in 2019 narrowly interpreted several of the law's so-called "guardrails"—restrictions in the law aimed at limiting certain high-income owners from claiming the deduction—effectively expanding the scope of the pass-through deduction and likely enabling more high-income people to avoid taxes.

Though the Biden administration should pursue full legislative repeal of the pass-through deduction, the administration should also withdraw portions of the Trump regulations and issue new rules that more robustly construe and apply the statutory guardrails to limit the ability of high-income people to avoid tax using pass-through entities. For example:

- New regulations should revoke the special exemptions in the 2019 regulations that allow high-income real estate brokers, insurance brokers, and businesses that conduct banking activities to qualify for the pass-through deduction despite statutory limitations on "brokerage services" and "financial services." New regulations should also revise other service-business definitions in the current regulations to better limit high-income owners from claiming the pass-through deduction for income that is predominantly derived from their own labor rather than their business ownership.

- New regulations should overhaul the existing regulations' formulation of the "principal asset test" in Section 199A(d), which excludes from the deduction any high-income business whose "principal asset" is the "reputation or skill of 1 or more of its employees or owners." This restriction was enacted in part to prevent a professional tennis player or movie star from forming herself into an LLC to dodge taxes on 20% of the income that derives from her individual skills and not from being a job-creating business owner.

  The Trump administration eviscerated this exclusion by interpreting it to mean only income from endorsement, licensing, or appearance fees was disqualified from enjoying the 20% deduction. The Treasury department should consider using one or more of the New York State Bar Association recommendations to reform this limitation and prevent vast amounts of high-end labor income from qualifying for the deduction.

- Treasury should use its authority to extend Section 199A(c)(4)(A), which excludes "reasonable compensation" from the deduction, to partnership income (instead of limiting it to that of S corporations). Similarly, new regulations should enact an anti-abuse rule that prevents partnerships from recharacterizing "guaranteed payments" to partners—which do not qualify for the deduction—as "priority allocations" of income that may qualify.

3. **Reform opportunity zones (Regulation and Executive Action), High Priority**
   The TCJA created the "Opportunity Zone" (OZ) tax break, but the law left many important implementation decisions to the Treasury Department. Almost all of these decisions were made in ways that favor investors, likely expand the cost of the provision, and largely fail to use the Treasury's authority to limit tax shelter activity or to help protect the communities where investments are made. Under current law, the OZ tax break expires after 2026. The program should not be extended absent clear evidence that it is benefiting communities in ways that are more cost effective than other policy approaches. The tax break should also be improved by administrative action while it is still in effect. For example:
   - The Treasury should enact robust information reporting requirements and compile the information in a publicly searchable database.
   - OZ properties can be owned by funds with multiple investors, which also own other properties not located in the special zones. But for fund investors to qualify for the OZ tax break, the IRS requires that "substantially all" of the fund's investments be in OZ properties. Treasury regulations now define "substantially all" as 70%—that share should be raised to 90%.
   - New regulations should require the Treasury Department to annually certify that OZ funds fulfill all the program's requirements. (This would replace the current "self-

certifying" system. The new certification process should apply similar standards as those used to assess Community Development Entities under the New Markets Tax Credit.

- New regulations should enact anti-abuse rules to limit the ability of firms to game the system and claim tax benefits without increasing economic activity in an opportunity zone.

4. **End the cherry-picking of cost basis to minimize taxable capital gains (Regulation), High Priority**

When an investor sells a portion of her holdings in a stock, mutual fund or other financial security that's been purchased in parts over time, she can use one of three methods to determine the cost of the part sold and therefore the gain or loss realized from the sale. She may use the average cost of all the parts of her holding; she may presume that she is selling the earliest-purchased part ("First In, First Out," or FIFO); or she may claim to be specifically identifying the part she is selling.

These methods may generate very different results. Consider for example an investor who purchased 100 shares of a mutual fund at $10 per share in 2010; 100 shares of the same fund for $15 per share in 2015; and made a third purchase of 100 shares at $20 per share on June 30, 2020. If on July 1, 2021, the investor sells 100 shares of the fund for $15 per share, she could either declare no gain, based on the average cost method; a gain of $500, based on FIFO; or a *loss* of $500, based on specific identification (assuming she identified the lot sold as the most expensive one).

Specific identification is a profitable fiction for investors in securities. Unlike, say, collectibles, shares in a stock or fund are all identical and so claiming to differentiate among them is simply a way to dodge taxes.

Treasury regulations should require investors to use FIFO to calculate their gains and losses for their securities, revoking the right to use average cost, specific identification, or any other method (i.e., revoke Treas. Reg. sec. 1.1012-1(c)(2), (3), and (4)). Investors would use FIFO for each of their accounts separately, which would mean brokers could calculate gains and losses without reference to any other account.

FIFO has been widely used for many decades in determining the cost of items sold. It is currently the default choice for investors who have not elected another method. FIFO simplifies determination of the holding period of securities: those held over a year are considered long-term and obtain preferential tax treatment when sold for a profit.

Adopting FIFO as the single allowable method for determining cost basis would make capital gains taxes fairer, simpler and a greater source of revenue from those best able to pay, since the top 1% own 54% of stock and mutual funds and the top 10% own nearly 90%, according to the Federal Reserve.

5. **Curb valuation abuse in retirement-account contributions (Regulation), High Priority**
   Retirement plans receiving tax-favored treatment are meant to guarantee working people a secure and dignified old age. They are not meant to allow the wealthy to further enhance their fortunes, which is a way many are now exploited. By limiting the ability of high-paid employees and other wealthy people to abuse the tax breaks offered by retirement systems, we can better provide for the later years of those who are not wealthy because they were not born rich or, despite years of hard work, never hit the professional jackpot, or because they belong to a group that has historically faced barriers to wealth accumulation, including women and people of color.

   One way higher-income taxpayers avoid retirement-plan contribution limits is by undervaluing assets they place in their accounts. A regulation could end this undervaluation abuse by limiting non-cash contributions to publicly traded securities for which the price is set every day. If instead taxpayers are allowed to continue contributing assets for which there is no publicly determined value, they should be required to supply "qualified appraisal reports" of such contributions, just as they now must for charitable contributions of property valued by the taxpayer at over $5,000. (These charitable- contribution appraisals are regulated by IRC § 170(f)(11) and Treas. Reg. § 1.170A-13(c).) We also urge the Treasury Department to work with Congress to cap the size of tax-free/tax-deferred retirement accounts.

6. **Revise the capitalization regulations for both tangible and intangible assets (Regulation), Medium Priority**
   Through two sets of expansive regulations, the Treasury Department has made it easy for business taxpayers, including wealthy individuals owning and operating investment businesses, to write off immediately ("expense") most costs associated with acquiring intangible assets (such as formulas and copyrights), and many of the costs associated with acquiring tangible assets (such as buildings and vehicles). These regulations depart from the statutory rules requiring the costs of acquisition be added to the "basis" of the asset ("capitalization"), delaying any tax benefit to the reduced capital gains realized on the asset's sale. Specifically, these regulations ignore a major Supreme Court decision (INDOPCO) requiring capitalization of such costs.

   Because businesses covered by these Treasury rules enjoy both full expensing and the ability to deduct interest payments, this regulatory stance invites abusive tax shelters. Taxpayers can borrow to fund investments that are only profitable because of the tax benefits. At least until Congress more fully limits business-interest deductibility, the regulations should be revised to better correspond with the intent and interpretation of the law by requiring capitalization for most expenses that produce lasting benefits.

7. **IRS crackdowns on phony land valuations (Regulation), Medium Priority**
   Some high-net-worth taxpayers have claimed large charitable contribution deductions for grants of easements restricting the upward development of buildings even though such development is already restricted under local zoning or historical-preservation

laws. The Obama-Biden administration proposed legislation to end these deductions, but Congress never acted. The change can be accomplished by regulation—see Hemel, The President's Power to Tax, 102 Cornell Law Review 633, 671-73 (2017). The IRS should initiate notice-and-comment proceedings promptly to end this abuse. The FY 2017 Green Book estimated it would raise $174 million over 10 years.

B. CLOSE INTERNATIONAL CORPORATE TAX LOOPHOLES

1. **Appropriately allocate expenses for multinational corporations to foreign income under GILTI (Regulation), High Priority**
Because the U.S. corporate tax rate is 21% and the Global Intangible Low-Taxed Income (GILTI) rate is only 10.5% it is advantageous for corporations to allocate deductions against domestic income subject to the higher rate. Current guidance provides multinationals with flexibility to allocate expenses disproportionately to U.S. income and not against GILTI income. The result of this expense allocation is to further erode the U.S. tax base and increase the subsidy for foreign earnings already created by GILTI's reduced rate. Treasury should issue revised regulations clarifying that expenses properly allocable to GILTI income should be allocated against GILTI and not against domestic income.

2. **Revoke improper high tax exceptions for GILTI (Regulations), High Priority**
Subpart F has since its enactment allowed an exception for income that is subject to foreign effective tax rate of at least 90% of the U.S. rate (currently 18.9%). There is no such statutory exception in GILTI. However, the Trump Treasury Department created such an exception. This loophole allows taxpayers to avoid GILTI as well as Subpart F. Also, GILTI is subject to limits that do not apply in Subpart F, such as only allowing current year taxes for foreign tax credit purposes and imposing an 80% limitation on foreign tax credits. The regulations creating the high-tax exception under GILTI should be revoked.

3. **Clarify application of BEAT for related party services (Regulation), High Priority**
Under the Base Erosion and Anti-abuse Tax (BEAT), certain payments to related foreign parties may be subject to an alternative minimum tax of 10%. Under section 482, no transfer pricing issue arises for certain services, such as back-office services, provided by controlled foreign corporations (CFCs) without any markup. A question arises under the BEAT when services are provided subject to a markup as to whether the entire sum paid should be subject to the BEAT or just the markup. The Trump Treasury Department ruled that only the markup is subject to the BEAT tax—a result that is very favorable to U.S. based multinationals but with no basis in the statute. Because the BEAT is an alternative minimum tax the better approach is for the entire amount of such services to be included in the BEAT calculation. The Treasury should revoke the previously issued regulations on this ground and issue new clarifying regulations that the entire amount of related party services is subject to inclusion in the BEAT.

4. **Reform transfer pricing and prevent earnings stripping (Regulations), High Priority**
U.S. and foreign multinational corporations dodge taxes by engaging in intercompany transactions with foreign affiliates. Doing so allows them to shift profits actually earned in the U.S. into jurisdictions where they might be able to take advantage of lower tax rates, more secretive or corporate-friendly tax rules, and inconsistencies between international tax regimes. While the global minimum tax deal—and legislative changes to U.S. law included in Build Back Better that are necessary to help implement that deal—will lower the incentive for taxpayers to engage in this type of tax dodging, it will not entirely address the problem.

   For example, even after the proposed reforms, corporations will still be able to use so-called "cost sharing agreements" to facilitate the transfer from the U.S. of valuable intangible assets, such as drug formulas and software code, to low- or no-tax foreign countries. These assets are then licensed back to an American company at inflated prices. This price padding lowers the reported profit, and therefore tax bill, of the U.S. firm, while artificially pumping up profits in tax havens. (The transferred assets can also be used to manufacture goods exported to the U.S. and other nations.)

   Cost-sharing agreements and similar arrangements are in theory required to be set at "arm's length," meaning that they should only be recognized for tax purposes if the deal is substantially similar to one than an independent party would strike. In practice, the arm's-length standard is hard to apply (especially as it relates to intangible property) and therefore is seldom used to police transfer pricing. The IRS should build off recent success in enforcing transfer-pricing abuse based on a renewed attention to a 1986 amendment to the Code that would analyze these transactions based on a commensurate with income or "CWI standard."

   Earnings stripping, like transfer pricing, is a way of avoiding taxes by reducing reported corporate income in a relatively high-tax jurisdiction while increasing it in a relatively low-tax area. In one form, the foreign-based parent of a U.S. subsidiary funds that subsidiary with high-interest loans. The pricey interest payments paid by the subsidiary to its parent (or a different affiliate) artificially depress American earnings, while harmlessly increasing profits in no- or low-tax foreign jurisdictions. The tax-dodging payments can also take the form of royalty payments from subsidiary to parent. Making the scheme worse, the "foreign" corporation is often really an American one that's swallowed a foreign firm and taken its foreign headquarters address strictly to avoid U.S. taxes (what's known as an "inversion").

   The IRS can use its current authority, including regulatory clarifications, to deter transfer-pricing and earnings-stripping abuses.

   A. Highest Priority: Stronger IRS Enforcement to combat transfer pricing abuse: One way to curb the exploitation of intellectual property already settled offshore is to fully apply a 1986 amendment to Code section 482 that allows retrospective enforcement of rules against earnings stripping. The IRS should be strongly encouraged to build on momentum in recent litigation to enforce section 482 by challenging long-existing cost-sharing arrangements (including at tech giants) that merit renewed focus, including under the CWI standard.

B. Improve Regulations to address transfer pricing abuse and earnings stripping:
   - Second Highest Priority: Transfer-pricing regulations should be updated and strengthened to prevent pricing practices used to shift profits to tax havens.
     a. The tax reform of 1986 tightened the rules on transfer pricing of intangible assets, and new regulations should make clear that cost sharing is subject to the CWI standards adopted by that amendment.
     b. Treasury could also strengthen IRS Reg. 1.482-1(b) by clarifying the use of a "rational actor" standard when evaluating transfer pricing arrangements. Final Treasury regulations promulgated in 2011 included "grandfathering" rules limiting application of improved regulations under section 482 to cost-sharing arrangements entered into on or after January 5, 2009 to ease the transition into new rules. After 10+ years there is no policy justification for grandfather relief for newly developed or acquired IP. The grandfather should be removed.
   - Lowest Priority: Treasury can also curb earnings stripping by expanding existing anti-abuse and substantial economic effect regulations into a full anti-earnings-stripping rule relying on various sources of authority within the Code to prohibit the use of excessive debt or royalty payments to reduce U.S. corporate taxes. Additional technical changes might be made, which we would be happy to discuss.

5. **Eliminate or restrict "Check the Box" (Regulation), Medium Priority**

American corporations with ownership interests in foreign corporations can avoid paying U.S. taxes on those companies' passive earnings (e.g., interest and royalties) simply by checking a box on an IRS form to make offshore subsidiaries and their passive income invisible for tax purposes. The "Check the Box" regulation instituted in 1996 was among the tax rules that encouraged U.S. corporations to accumulate nearly $3 trillion of profits in low tax jurisdictions—much of it shifted from the U.S.—by the time the TCJA was enacted at the end of 2017.

The TCJA changed the treatment of offshore corporate profits and the ways in which Check the Box can help American corporations dodge taxes. By letting firms manipulate their reported number of foreign subsidiaries and their relationship to one another, Check the Box can lower the tax due on GILTI and increase foreign-tax credits. Attempts to curb Check the Box began in 1998, soon after the regulation was promulgated, then continued through proposed Obama administration budgets. We urge the Biden Administration to finally remedy the situation.

NOTE: The legislatively created Controlled Foreign Corporations (CFC) Look-Through Rule similarly excludes from taxation certain passive income transferred between related offshore entities. The CFC Look-Through Rule (Code 954(c)(6)) was adopted as a temporary measure in 2006 and has been extended since then, most recently in 2020 through 2025. It codifies Check the Box and should be eliminated legislatively.

6. **Protect and expand U.S. source taxation base (Regulation), Medium Priority**
   Even though much business is now international, taxation remains local. A company can be subject to taxation in a particular jurisdiction if it is deemed to have a "taxable presence" in that locale. The Biden administration should modernize regulations governing when the U.S. activity of foreign-based firms constitutes a taxable presence in America. The updated definition should include remote offshore sales of services to American companies by "platform companies" with little physical U.S. presence. Since the Tax Code does not define what constitutes a U.S. trade or business subjecting a foreign entity to U.S. taxes, the Biden administration has the latitude to adopt by regulation something like the "substantial digital presence" threshold used by the European Union (EU) to evaluate the taxability of foreign online companies. Adopting this rule will also help in negotiations with the EU over proposals from the Organization for Economic Cooperation and Development (OECD) for how to allocate the taxable income of digital companies working across national borders (the OECD "Pillar 1" proposals).

7. **Prevent excess foreign tax credits for U.S. corporations (Regulation), Medium Priority**
   American corporations with foreign operations are allowed to deduct from their U.S. tax bill any foreign taxes paid. This credit is supposed to be reserved for taxes only, not payments to foreign governments in exchange for an economic benefit, such as royalties on the extraction of natural resources. But enforcement of this rule has been weakened over the years by unfavorable court rulings, especially in regard to the oil and gas industry. The Treasury should promulgate a rule that restricts foreign tax credits to the rate paid under the general income tax of the other nation, thereby excluding royalties and other ineligible payments.

8. **Make it easier to prove control of foreign assets by U.S. taxpayers (Regulation), Medium Priority**
   Legal proceedings begin with certain presumptions—such as the presumption of innocence of criminal defendants—that are only supposed to change in the face of credible evidence (these are known as "rebuttable presumptions"). The Treasury should establish a rebuttable presumption that any foreign account a U.S. taxpayer opens, sends money to, or receives money from is controlled by that taxpayer. This new rule would be targeted at institutions not already covered by the reporting requirements of the Foreign Account Tax Compliance Act (FATCA), including insurance companies, whose products can be used to cloud financial transparency. The same rebuttable presumption on control should apply to foreign entities that a U.S. taxpayer forms, sends money to, or receives money from. This sensible shift in the burden of proof would make it easier

to curb offshore tax evasion. [This reform is included in the Stop Tax Haven Abuse Act of 2021 (S. 725, Section 202(g)]

9. **Increase corporate transparency (Regulation), Medium Priority**
One key to improving the U.S. corporate tax system is better information. Requiring America's largest multinational corporations to file public rather than confidential country-by-country (CbC) reports with the IRS will enable policymakers, academics, and the public to better understand where U.S. multinationals pay tax and how much. Requiring multinationals to file public Advanced Pricing Agreements (APA) will enable policymakers, academics, and the public to better understand how those multinationals are moving profits offshore. Making those filings public is within the existing regulatory authority of the IRS or the Securities and Exchange Commission (SEC), as applicable (with the Treasury signaling to the SEC support for such reforms also being important) and would also encourage U.S. allies to support similar actions as part of the ongoing OECD effort to curb multinational corporate tax avoidance and abuse. Providing more accurate, timely and comprehensive corporate data would lead to improved tax policies and procedures.

10. **Reform U.S.-controlled offshore corporations (Regulation), Low Priority**
When a foreign financial entity like a trust or partnership opens a U.S. bank, brokerage or other account, the institution offering the account is not required to supply the same information about that account to the IRS as the institution must supply on the accounts of U.S. taxpayers. Because this is true even if a U.S. taxpayer has a financial interest in the foreign entity opening the account, the current rules facilitate offshore tax dodging. The Treasury should consider authority it already has to leverage information it can gather from U.S. financial institutions and other entities or intermediaries to reduce offshore tax abuse by aligning IRS reporting rules with FATCA and anti-money laundering rules to require financial institutions hosting accounts for offshore entities controlled by U.S. persons to report those accounts to the IRS as U.S. (rather than foreign) accounts. These efforts may complement efforts by President Biden to expand reciprocal information exchange under FATCA.

C. CLOSE FINANCIAL INDUSTRY TAX LOOPHOLES

1. **End private equity's abuse of the tax system (Regulations), High Priority**
"Private equity" refers to hedge funds and other entities that pool rich people's money and are allowed to make riskier investments than, say, mutual funds, which are marketed to small investors and are more heavily regulated. The industry's most famous tax abuse is "carried interest": private equity traders, who are compensated in part based on the returns they deliver to investors, pretend that what is in fact a salary for work performed is instead a capital gain, which is taxed at a much lower top tax rate—20% rather than 37%.

The glaring injustice of taxing carried interest as capital gains continues after the loophole-ridden, industry-drafted Sec.1061 of 2017's Tax Cut and Jobs Act failed to curb the abuse in any substantial way. Treasury should replace existing revenue procedures (Rev. Proc. 93-27 & 2001-43), which allow for the tax-dodging treatment of carried interest, with new ones promulgated pursuant to its authority under Sec. 707(a)(2)(A) that would close the loophole.

Treasury should also consider other regulatory fixes, including treating carried interest as a below-market-rate loan (as described in Sec. 7872), which would make the interest savings taxable; treating portfolio companies as inventory, which would make their sale equivalent to the sale of merchandise in a store, subjecting any profits, like those of store sales, to ordinary income-tax rates; or treating carried interests as a derivative subject to mark-to-market taxation.

The carried interest loophole is only one way that private equity fund managers game the tax code. The administration should strengthen and finalize regulations (Prop. Treas. Reg. § 1.707-2(c)) to prevent managers from using "fee waivers" to camouflage management fees as lower-taxed capital gains.

2. **Require derivatives to be marked to market (Regulation), High Priority**
Derivatives are financial instruments that derive their value by reference to other assets, liabilities or indexes of securities. Derivatives include futures, options, forward contracts, notional principal contracts, and many other arrangements. Investors can invest in derivatives either on an exchange or off (i.e., over the counter or "OTC").

The current taxation of derivatives is complicated and inconsistent: there are different tax rules for different derivatives, for different uses of the same derivative, and for different taxpayers owning the same derivative. Taxpayers as a result often use derivatives to manipulate their tax liability. For example, investors can use exchange-traded "notes" to wrap derivatives around investment strategies in order to convert ordinary income and short-term capital gains into long-term capital gains, thus deferring taxes and paying lower rates.

Derivatives should be "marked to market." That is, a derivative should be treated as if sold for its fair market value at the end of the year, with the taxpayer recognizing the gain or loss and paying any tax due. Any gain or loss from the deemed sale would be considered regular income, not a capital gain, and therefore subject to the rules and rates covering regular income.

The accounting profession has largely shifted to the mark-to-market system to value derivatives. In 1998, the Financial Accounting Standards Board (FASB), the industry's rule maker, issued "Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities." It was meant to address two key problems: (1) the economic effect of derivatives was not transparent in basic financial statements; and(2) the accounting guidance for derivative instruments and hedging activities was incomplete, inconsistent, and difficult to apply. The FAS 133 rules required companies to measure all derivatives on their balance sheet at "fair value," which is very similar to fair market value for tax purposes.

The IRS already requires mark to market for securities dealers and owners of regulated futures contracts. Treasury should, by regulations, require the mark-to-market method of accounting for the taxation of all derivatives. The new regulations (revising Treas. Reg. sec. 1.446-3) would require taxpayers to account for a derivative as if it were sold at the end of each year and would require any gains or losses to be recognized annually (subject to other rules, like those for hedges). These gains and losses would be ordinary.

Taxing derivatives on a mark-to-market basis is also crucial for denying wealthy taxpayers access to schemes that avoid other tax increases on capital gains. Rich investors have used derivatives to mask what are for all practical purposes profitable sales in order to dodge capital gains taxes for years on end.

3. **Prohibit disguising dividends paid to private equity funds as monitoring fees (Guidance), Medium Priority**
   Private equity funds pool the money of wealthy investors to buy and sell companies not yet traded on a public stock exchange. One way a private equity fund makes money is by forcing the companies it buys—its "portfolio companies"—to pay it a so-called "monitoring fee," supposedly for management or consulting services offered by the private equity firm. Such payments are claimed as deductions by the portfolio company on its taxes, lowering net income and therefore taxes due. But the private equity firm sets the terms of these monitoring-fee agreements, which are often vague and typically don't require the fund to provide any minimum level of service. Therefore, the monitoring fee payments from the portfolio companies should be re-characterized as dividends, which are not deductible.

   As further proof that these monitoring fees are unrelated to any actual services performed, if the management agreement is terminated prematurely the firm is often entitled to a lump sum payment representing the present value of future periodic fees—fees for services that will never be provided. Many of these termination payments are for tens of millions of dollars. In some cases, the private equity firm can unilaterally terminate the management agreement and still receive the full present value of the contract.

   Monitoring fees are often particularly high when a group of private equity firms collectively buy a company (a so-called "club deal"). Another indicator that the payments flowing from the acquired company are dividends and not fee payments is that the money is split among the members of the "club" according to their share of the investment, not any share of purported services performed.

Improper deductions taken on dividends disguised as monitoring fees deprive the federal government of hundreds of millions if not billions of dollars of tax revenue annually. They also facilitate the private equity industry's business model of stripping large amounts of capital out of their portfolio companies, which impedes growth, increases the risk of financial failure and imperils jobs.

Despite the abuse being reported in the Wall Street Journal in 2014, the private equity industry has continued to include monitoring fees in new deals. The IRS should act aggressively to end this blatant tax evasion by clarifying that private equity funds cannot disguise dividends as deductible service-fee payments.

4. **Deny deductions for interest that is unlikely to be paid (Regulation), Medium Priority**
   Taxpayers that use the "accrual" method of accounting may deduct their obligation to pay interest as it arises, regardless of when, or even whether, they actually pay the amount due. Yet on the other side of the loan, the holders of distressed debt may avoid reporting any interest income from that debt under the "doubtful collectability" doctrine (Corn Exchange Bank v. U.S., 37 F.2d 34 (2d Cir. 1930)). The same rules should apply to both sides of a loan: taxpayers that are unlikely to make an interest payment should not be able to take an interest deduction until the payment is made or the holder of the debt reports the unpaid interest payment as accrued income.

   This ability to deduct unpaid interest may have contributed significantly to Donald Trump's eye-popping $916 million loss reported on his 1995 tax return that probably wiped out any tax liability for years. Trump's failing Taj Mahal casino was able to deduct the interest payments on its bonds for federal income tax purposes, even though it never actually made the payments. Meanwhile, the bondholders probably stopped reporting the interest income. As a remedy, the administration could issue a regulation specifying that issuers of debt are not able to deduct interest that is unlikely to be paid. We suggest a presumption that interest is unlikely to be paid, if the holders of the debt fail to report the interest.

5. **Demand true compliance with REIT qualification rules (Guidance), Medium Priority**
   A Real Estate Investment Trust (REIT) is a mutual fund for real estate. Investors pool their money so that instead of each owning individual properties, they all own shares in a company that invests in rent-generating office buildings, apartment houses, shopping malls and more, then distributes that rent income to shareholders as dividends. A REIT offers investors several tax advantages: it is exempt from corporate taxes, and its shareholders are allowed (subject to exceptions) to subtract 20% of their REIT dividend income before figuring their taxes.

   Among the criteria a real-estate investment company must meet to qualify as a REIT is that it has at least 100 shareholders. To meet this requirement, many REITs with only a handful of substantive investors issue two classes of stock: voting and non-voting, with the non-voting issued in private placements to just enough "investors" to meet the 100 shareholders requirements. These non-voting investors usually have very little financial interest in the REIT; many times, they are simply a bunch of names provided by so-called "REIT Service Companies" in exchange for an annual payment.

This dodge allows a small group of wealthy taxpayers to enjoy all the tax advantages of a REIT without fulfilling the system's original intent of opening up real estate investment to middle-income households. The only determination by the IRS that such schemes satisfy the 100-shareholder requirement came in a private letter ruling (I.R.S. P.L.R. 8342016 (July 13, 1983)). According to the I.R.C., taxpayers may not rely on PLRs as precedent (I.R.C. 6110(k)(3)). The IRS should clarify that this REIT PLR is not the IRS position, and issue official guidance stating that such nominal holdings do not meet the 100 shareholders requirement.

6. **End mutual fund dodging of legal limits on speculation in risky commodities (Revenue Policy), Low Priority**
   IRC 851(b)(2) allows mutual funds to avoid paying corporate-level tax only if they derive at least 90% of their income from "securities" and no more than 10% from other sources, including commodities. These restrictions encourage mutual funds to invest in U.S. corporations, jobs and innovation, rather than simply bet on changes in commodity prices. But since 2006, IRS private letter rulings have eviscerated the limit on commodity speculation by authorizing mutual funds to claim that owning offshore vehicles and financial instruments investing in commodities are really "securities" investments under the tax code—thereby unleashing a flood of commodity speculation and market volatility, while depriving U.S. securities markets of stable investment pools. A 2011 bipartisan Levin-Coburn letter cited a Senate investigation into this issue and recommended withdrawing the IRS private letter rulings, but the IRS has not taken any action and mutual funds have continued to derive disproportionate income from commodity speculation. An example is here. The IRS can stop circumvention of the statutory limit on allowable investments by tax advantaged mutual funds by withdrawing the permissive IRS private letter rulings. [Taken from 2012 Levin-Coburn Senate hearing]