8 percent if they adopted income taxes with bases of average breadth. Delaware could only achieve that goal with a base of above-average breadth — that is, with an implicit sales tax base equal to 50 percent of personal income. Among the states without sales taxes, it would be most difficult to implement one in Oregon.

Conclusion

Among the 44 states with significant income tax revenue, only a few could repeal their income taxes, replace the lost revenue with sales taxes, and keep sales tax rates below 8 percent with their current sales tax base (or, for those without sales taxes, with a tax base equal in breadth to the average of other states). They are New Hampshire, Alaska, Montana, Hawaii, and Florida. Two more states, New Mexico and Alabama, might also be able to repeal their income taxes and keep sales tax rates below 8 percent if they aggressively expanded their sales tax base. In general, states where a tax swap is most likely have relatively low income tax collections and relatively low sales tax rates.

If states already had broad-based consumption taxes in place, a widespread phaseout of state income taxes might be a real possibility. Concerns about regressivity could be addressed with a sales tax rebate to low-income households. But as long as states rely on sales taxes that exclude most services and include business inputs, the difficulties in most states will be insurmountable and the desirability questionable. ■

NEWS ANALYSIS

Camp's Bold Blueprint Leads The Way for Tax Reform

By Marie Sapirie — msapirie@tax.org

It is a truth universally acknowledged that a politician in possession of a worthwhile tax idea must want a glowing headline. Congress has done little that is praiseworthy on taxes lately, but the tide may be changing.

House Ways and Means Chair Dave Camp, R-Mich., is taking a refreshing approach to tax reform. He wants to find the right policy answers and make them law. With the release of his discussion draft on financial instruments, he has demonstrated that he is serious about tax reform. There is no revenue score for his draft, because raising revenue is not the point. The point is to make the tax code more rational. Camp has significantly advanced the ball, but he must keep up the momentum or else miss the short window available for legislative action. (Prior coverage: *Tax Notes*, Jan. 28, 2013, p. 399.)

> ***Camp has significantly advanced the ball, but he must keep up the momentum or else miss the short window available for legislative action.***

In webcasts on February 7 and 8 sponsored by KPMG LLP and Deloitte LLP, E. Ray Beeman, majority tax counsel for the Ways and Means Committee, insisted, "This really is about policy. This is about trying to find what the right answer is without regard to where it lands on the revenue table." The theatrical and sometimes polarized hearings that the committee has held might indicate otherwise, but Beeman emphasized that the point of the discussion drafts is to get comments from taxpayers and practitioners who work on the issues.

In addition to positive headlines, politicians need simple sound bites. Camp's is about tax rates. When Camp released his first discussion draft on moving to a territorial system, the proposal was couched in terms of a rate reduction for individuals and corporations. The tax code in general, and its provisions regarding financial products in particular, may badly need an overhaul, but the merits of curbing financial engineering for tax purposes are tougher to condense into a Facebook post than the benefits of lower marginal rates.

Camp appears to be executing a well-planned strategy for ensuring that the more politically charged aspects of tax reform don't torpedo his efforts. His drafts are released with enough time for comments to be prepared and reviewed, with a vote still possible before the 2014 midterm elections.

Camp knows that personal items like the mortgage interest deduction and the exclusion for employer-sponsored healthcare will be tough to address. The key to his reform effort is that it is comprehensive. The current draft and its predecessor in the international area are entitled "A bill to amend the Internal Revenue Code of 1986 to provide for comprehensive income tax reform." The international and financial instruments drafts go a long way toward showing how serious Camp is in this effort, but still to come are hearings, draft legislation, and eventually, revenue estimates and their corresponding tough choices.

Camp seems to be hoping that by fixing the more technically challenging problems first, he can blunt some of the need to raise revenue at the cost of eliminating the tax benefits that are most popular with voters. The provisions in the financial instruments draft may be a mixed bag in terms of their revenue-raising ability.

Beeman said that Ways and Means had focused on international and financial instruments first because they are the "more complicated, technical areas of tax law" for which a pre-legislative review of proposals is more beneficial. There was also a wheel-greasing purpose in starting with areas that do not directly affect most voters' Forms 1040.

It's Just a Draft

The committee members know the draft isn't perfect, and they are receptive to suggestions for improving it. Beeman admitted that some technical aspects had been overlooked.

The definition of a derivative was written broadly, but it will likely be adjusted. Lucy W. Farr of Davis Polk & Wardwell LLP said it covers an agreement to sell a privately owned business if the transaction closed the following year. Beeman agreed the provision is probably not intended to be so broad that it encompasses buy-sell agreements.

By leaving convertible debt within the definition of a derivative, the committee was only trying to stir the pot. "The staff spent a lot of time internally debating whether convertible debt should be in or out for the reason that it's more retail-like than many things that are covered," Beeman said. "Excluding convertible debt probably generates more comment than including it, so it's a process-strategic way of bringing up the issue."

Near universal application of marking to market could result in inefficient sales in order to pay taxes. Hank Gutman of KPMG LLP said that although that isn't desirable, "you can certainly mark to market, as long as you are comfortable with your value and you set up an account." In the account, the taxpayer would annually record the value and what the gain would have been, and tax would be deferred until the taxpayer left the position, at which point an interest charge would neutralize the value of deferral.

Beeman said the committee hadn't thought of that approach, and he suggested that the comments on the draft would lead it to consider alternatives.

Mark Price of KPMG criticized the choice to require derivatives generally to be marked to market. If the principles are to eliminate the ability of taxpayers to arbitrage, and also to provide some uniformity around derivatives, other lines could be drawn, he said. He suggested distinguishing between circumstances when there is a high potential for abuse, such as in the publicly traded market, and situations with a low potential for abuse, such as in the illiquid space. There are alternatives, Beeman conceded. However, the drafters wanted to find a single accounting method that could be broadly applied, and they were not unaware of what was happening on the financial accounting side. They believed that mark-to-market was the best route, and that theory was buttressed by mark-to-market's history of gradual legislative adoption.

One step along the road was the introduction of mark-to-market for securities dealers in 1993. In adopting that rule, it was hoped that concerns about valuation and ability to pay the tax could be addressed, said Steve Rosenthal of the Urban Institute. "Securities dealers were maintaining securities inventory that they were then valuing at the lower of cost or market, so they could value the securities — they were very sophisticated," he said. "The securities, we felt, were sufficiently liquid that they could borrow against them and pay the tax." Beeman pointed out that optional marking was introduced for passive foreign investment companies, which suggested a growing level of support for mark-to-market.

Frank Strong of Deloitte worried about the effect of moving to mark-to-market. "Mark-to-market creates tremendous volatility in taxable income," he said, noting that corporations would still be taxed under a realization-based approach.

Navigating the valuation and ability to pay questions in the discussion draft will present new challenges, but probably not insurmountable ones. Rosenthal suggested that one way to solve the valuation problems is to ask the securities dealer counterparty to share its valuation for purposes of section 475 with the customer. "You could have consistency and conformity between how the dealer is valuing the derivative and how the other side of the transaction is valuing the derivative so the fisc would not systematically be shortchanged,'' he said.

The decision to deem the income and expenses from derivatives ordinary income was likewise an attempt to introduce uniformity, said Beeman. ''The choice of using ordinary as opposed to capital or something like 60/40 in part goes to the question of what is the underlying policy rationale for the capital rate preference,'' he said, adding that it is reasonable to ask whether the things that qualify for a reduced rate support the policy of having that rate.

''Uniformity is first and foremost. This is what this proposal is all about,'' Beeman emphasized. Rosenthal agreed: ''We have far too many flaky rules for derivatives. I think the only uniform way of taxing them is through mark-to-market.'' Rosenthal added that if the draft becomes legislation, it should probably be limited to positions that otherwise might be marked for financial reporting purposes and should exclude normal commercial transactions.

> ***'We have far too many flaky rules for derivatives. I think the only uniform way of taxing them is through mark-to-market,' Rosenthal said.***

One aspect of derivatives taxation that is notably absent from the draft is sourcing rules, said Viva Hammer of Brandeis University. Source of income needs to be addressed, and one way to do that is to modernize the rules under reg. section 1.863-7 to address international derivatives, she suggested. ''They have to develop a theory about why we are or aren't withholding on derivatives,'' she said.

The provision to limit the extent to which an issuer of debt recognizes income when the debt is restructured or modified came from American Bar Association Section of Taxation proposals. Practitioners fear that under the discussion draft, people who buy debt instruments from lenders at a significant discount would have a lot of phantom income that would be taxable. ''We're still looking at the holder's side,'' said Beeman. ''Its exclusion was not intended to say we've made a decision that we're not going to do anything on that side.''

The committee staff is likely to reconsider the draft provision on current inclusion in income of market discount. ''We need to revisit the drafting of that, because I'm not sure we quite got it right,'' said Beeman. The ABA tax section's proposal that the draft adopted is a trade-off that requires current accrual of market discount, coupled with a cap so that any creditworthiness-related discount will be outside the market discount rules.

The wash sale rules are incomplete. ''What we've done is just one little aspect of the wash sale rules, but I think a broader update might be good,'' said Beeman, adding that suggestions were welcome. The drafters took the IRS's approach in making losses permanently disallowed in cases of acquisition of substantially identical stock or securities by the taxpayer or a related party, but, Beeman said, ''I don't think we would want to change the wash sale rules from wash deferral to wash disallowance, if there's a way to preserve the deferral aspect.''

The average basis reporting provision may be an attractive choice for taxpayers because of the rising stock market, Rosenthal said. The provision would eliminate some tax planning opportunities. ''This kind of a proposal certainly reflects the school of thought that a holding of substantial identical securities is fungible,'' said Beeman. He added that mutual funds had asked for that treatment years ago.

Rosenthal said there is a transition issue for stock and mutual fund interests that several years ago had not been subject to brokers' basis reporting, because in that situation investors will have to make their own average basis calculations. That could be a challenge, he said.

Hammer added that integrating Camp's comprehensive draft into the complexity of the derivatives laws would require care to ensure that there is no unworkable overlap after the final bill is signed. ''They have to make sure that they really scrub the Internal Revenue Code so that they don't leave things that don't make sense,'' she said. But Hammer said the draft was a good start. ''The purpose of tax reform is to make the rules more understandable and easier to comply with and more fair. This law does all those things,'' she said.

CUT Loopholes Act

While tax practitioners were poring over the Camp financial products draft, Sen. Carl Levin, D-Mich., introduced the Cut Unjustified Tax (CUT) Loopholes Act, which has become his annual not-so-funny valentine to U.S. multinationals. The act is a repackaged version of Levin's prior proposals that indicate his willingness to maintain worldwide taxation through thick and thin. (Prior coverage: *Tax Notes*, Feb. 20, 2012, p. 951.) This year's iteration features the same carried interest provision that has become a staple of Democratic tax proposals. Levin would require producers to pay into the Oil Spill Liability Trust Fund to cover the costs of oil produced from tar sands.

If some version of Levin's proposal becomes the bargaining position for Democrats, it could stall the momentum that Camp has built up on tax reform.

There is reason to hope that Democrats might consider abandoning the plan to reinforce the anachronistic worldwide tax regime in the CUT Loopholes Act. The Ways and Means Committee announced on February 13 that it has formed bipartisan tax reform working groups to examine specific tax issues. In his State of the Union address, President Obama said that comprehensive tax reform can be accomplished if Republicans and Democrats work together. Repeatedly proposing a handful of pet provisions is neither collaborative nor productive. While Levin's plan looks to the past, Camp's drafts form a blueprint for the future. ■

REIT Spinoff With Leaseback Requires an Active Business

By Amy S. Elliott — aelliott@tax.org

If a real estate investment trust is spun off and leases its real estate assets back to the operating company, the active trade or business (ATB) requirement of section 355 may not be met unless the spun-off REIT contains operating assets other than real estate that satisfy the ATB requirement, according to Mark Weiss, branch 6 attorney, IRS Office of Associate Chief Counsel (Corporate).

''If you take out those operating assets, and you're just left with payments going back and forth, you might have some issues,'' Weiss said February 12 at a District of Columbia Bar Taxation Section Corporate Committee luncheon. ''Historically, I don't think that's good enough to get you to ATB,'' he said, although he acknowledged that the circumstances of each case will control the outcome.

The question arose in a discussion of facts matching Penn National Gaming Inc.'s (PNG) November 15 announcement that it had received a private letter ruling stating that it could spin its real estate assets into a newly formed publicly traded REIT to separate them from its operating assets. PNG operates slot machine gambling facilities.

> ***'If you take out those operating assets, and you're just left with payments going back and forth, you might have some issues,' Weiss said.***

PNG's transaction isn't final, but the company is the first to attempt a REIT spinoff through a so-called OpCo-PropCo transaction, in which OpCo is the operating entity following the spinoff and PropCo is the newly formed spun-off REIT. The IRS has yet to release a redacted version of the ruling, and PNG wasn't named during the luncheon discussion. (Related analysis: *Tax Notes*, Jan. 7, 2013, p. 127.)

For a spinoff to be tax free under section 355, it must satisfy the ATB requirement of section 355(b). Under Rev. Rul. 2001-29, 2001-1 C.B. 1348, the rental activities of a REIT can satisfy the ATB requirement.

Jay Singer of Deloitte Tax LLP said that the proposed transaction ''seems to indicate that despite Rev. Rul. 2001-29, they may not have been relying on their real estate activities alone to satisfy'' the ATB test. He said it appears that the taxpayer's PropCo will own a taxable REIT subsidiary containing other operating assets.

Singer said that in the past, the OpCo-PropCo transaction has also been referred to as a ''McREIT''