Report No. 1030

NEW YORK STATE BAR ASSOCIATION TAX SECTION

PRELIMINARY REPORT ON THE DIVIDEND EXCLUSION PROPOSAL

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TABLE OF CONTENTS

New York State Bar Association Tax Section

Preliminary Report on the Dividend Exclusion Proposal[1]

On January 7, 2003, the Bush Administration announced plans to implement a Dividend Exclusion proposal, with the stated objective of eliminating the double taxation of corporate income. The topic of Corporate Tax Integration has been the subject of extensive research and writings over many years.[2] The United States generally imposes tax both at the corporate and shareholder levels, a system that is often referred to as a classical tax system. Various other developed countries of the world have implemented, in varying degrees, more integrated systems of taxation of corporate income, designed to produce more uniform levels of tax on capital income. Several theoretical models, including a Dividend Exclusion model, have been developed to implement, in whole or in part, an integrated tax system.

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1 This Report was prepared by the Corporations Committee of the New York State Bar Association Tax Section, chaired by Kathleen Ferrell and Jodi Schwartz. Charles Morgan was the principal author. Helpful comments were received from: Kimberly Blanchard, Dickson Brown, Samuel Dimon, Kathleen Ferrell, Gary Friedman, Patrick Gallagher, Edward Gonzalez, David Hariton, Robert Jacobs, Charles Kingson, Jiyeon Lee-Lim, Robert Levinsohn, Richard Leongard, David Miller, Deborah Paul, Richard Reinhold, Matthew Rosen, Michael Schler, and Lewis Steinberg.

2 See for example: Treasury Department Report on Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once (1992) ("Treasury Report"); Treasury Department: A Recommendation for Integration of the Individual and Corporate Tax Systems (December 11, 1992) ("Treasury Recommendation"); ALI Federal Income Tax Project, Integration of the Individual and Corporate Income Taxes, Reporter's Study of Corporate Tax Integration (March 31, 1993).

The essential features of Treasury's Dividend Exclusion proposal were set forth in the "Green Book" language released on February 3, 2003.[3] In addition, on February 27, 2003, legislation was introduced in the House of Representatives (H.R. 2) and the Senate (S. 2) (hereafter the "Bills") to implement the proposal.[4] We recognize the Dividend Exclusion proposal may undergo further changes and refinements over time. We look forward to providing ongoing comments and suggestions.

The New York State Bar Association Tax Section is not taking a position as to whether, from a tax policy perspective, the Dividend Exclusion proposal is desirable. This Report assumes that a dividend exclusion proposal will be enacted. At your request, we have focused our attention in this Report primarily on a limited number of issues we believe should be addressed to facilitate administrability of the Dividend Exclusion proposal and to safeguard its application to ensure that the rules designed to eliminate the double taxation of corporate income are not in turn used to reduce or eliminate even a single level of taxation of corporate income.

The central feature of the Dividend Exclusion proposal is that, to the extent tax has been imposed at the corporate level (after-tax earnings will make up the excludable dividend amount ("EDA")), corporations will be permitted to pay excludable dividends to shareholders to the extent of EDA. Gains on shares of

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3 General Explanations of the Administration's Fiscal Year 2004 Revenue Proposals, Department of the Treasury, February 3, 2003, pages 11-22.

4 H.R. 2 (introduced by Chairman Thomas) and S. 2 (introduced by Senators Nickles and Miller).

stock, however, although reduced by adjustments for undistributed EDA, will remain subject to taxation, and shareholders will continue to be composed of a mixture of both taxpayers and tax exempt entities. This combination of factors: (i) the introduction of a new category of exempt income for taxpayers (i.e., excludable corporate dividends); (ii) the significant tax distinction between income derived as excludable dividends and income derived as taxable capital gains; and (iii) the fact that tax exempt investors will continue to represent a sizable portion of the shareholding public and generally will not pay tax on dividends or capital gains, could, if left unattended, be responsible for the design of a number of transactions that could undermine the tax policy objectives associated with the Dividend Exclusion proposal.

We recognize Treasury is fully aware of these possibilities and, as discussed below, has incorporated into its proposal a number of defensive measures designed to address them. The 1992 Treasury Report on Integration also highlighted a number of these concerns, and others have written about the need to incorporate appropriate protective features in any legislative proposal on this topic.[5] We have set forth below three relatively simple examples to illustrate some of the more important types of transactions for which safeguarding provisions will be appropriate. Although Treasury's current Dividend Exclusion proposal and the Bills contain provisions that appear designed to address the more obvious forms of tax

5 See for example: Treasury Report (1992); Schler, Taxing Corporate Income Once (or Hopefully Not at All): A Practitioner's Comparison of the Treasury and ALI Integration Models, 47 Tax Law Review 509 (1992); Yin, Corporate Tax Integration and the Search for the Pragmatic Ideal, 47 Tax Law Review 431 (1992).

abuse potential reflected in these examples, the examples and the following discussion also are intended to highlight the need for Treasury to implement practical and administrable rules to prevent or mitigate the undesirable tax consequences that otherwise could arise from similar, though less extreme, types of transactions.

Basis Reduction Example[6]

Corporation Z has either (i) an asset with an adjusted tax basis of $0 and a fair market value of $100 or (ii) $65 of cash, representing $65 of after-tax earnings in the form of an EDA that has not yet been allocated to shareholders. Assume C, a tax exempt entity, is the sole shareholder of Corporation Z. Assume C sells its Corporation Z stock to D, a taxpayer subject to a 35% marginal tax rate and capable of absorbing capital losses. In either case, absent application of some kind of basis reduction or loss limitation rule, D should be willing to pay $100 for the Corporation Z stock. In the first situation, after D acquires the stock, Corporation Z could sell the asset for $100, pay corporate tax of $35 and distribute a $65 excludable dividend to D. D would then have a potential $100 capital loss in the stock, which loss could offset a $100 short term capital gain otherwise taxable at a 35% rate. In the second situation, after D acquires the stock, Corporation Z could distribute a $65 excludable dividend to D. D would then have a potential $100 capital loss in the stock, which could offset a $100 short term capital gain otherwise taxable at a 35% tax rate. In both situations, the net effect could be to eliminate the effect of the corporate-level tax paid by Corporation Z.

Streaming Example

Corporation X has $300 of cash, including $100 of after-tax earnings in the form of an EDA that has not yet been allocated to shareholders; Corporation X has two shares outstanding. One of the shares is held by A and the other is held by B. A and B each has an adjusted tax basis in its shares of $100. A is a taxpayer and B is a tax-exempt entity. If Corporation X distributes a $100 dividend, $50 each to A and B, and then distributes the remaining $200 in liquidation, there would be no gain or loss to Corporation X or to the shareholders. If instead, Corporation X redeems B for $150 in a transaction characterized as a capital transaction under Section 302,

6 As suggested in the text, the examples presented herein have been constructed to illustrate certain basic principles. We recognize that the fact patterns are simplistic and, to some extent, may be capable of being characterized for tax purposes in a different manner from that presented herein. The reader should assume that actual fact patterns would be constructed with more care to achieve the desired tax objectives.

declares a $100 dividend to A, and then distributes $50 in liquidation to A, absent a special basis reduction or EDA allocation rule of the type Treasury has proposed, A could derive both a $100 excludable dividend and a $50 capital loss. Corporation X might consider a number of other approaches to "stream" otherwise taxable payments to tax exempt shareholders and excludable dividends to taxable shareholders, so as to maximize the after-tax returns of the shareholders.

Dividend Stripping Example

Corporation Y is a public corporation with a long history of paying regular quarterly dividends. Assume that on March 1, 2004, Corporation Y declares an excludable dividend of $100 per share, to be paid on March 31, 2004 to shareholders of record on March 15, 2004. Assume that the price of Corporation Y's stock, currently $1,000 per share, is expected to decline by $100, an amount equal to the declared dividend, just after the dividend record date. Assume that on March 14, 2004, A, a tax exempt shareholder of Corporation Y, sells its stock in Corporation Y to B, an individual taxpayer, for $1,000. Assume B contemporaneously arranges to sell the Corporation Y stock for $900 following the record date. Absent a provision like Section 246(c) of the Code, this type of transaction would enable B to combine a $100 excludable dividend with a $100 capital loss.

The above examples illustrate, in broad fashion, some of the potential problems that will exist in a system in which corporations are permitted to distribute excludable dividends, sales of stock remain subject to tax and shareholders continue to be composed of tax exempt and taxable persons. Under current law, the 70% and 80% dividends received deduction provisions present many of the same issues. Over the years, there have been a number of legislative and administrative responses to the more obvious areas of concern. The reality is, however, that the Dividend Exclusion proposal, by combining an increase in the exclusion percentage with a significant expansion of those taxpayers eligible to claim it, will substantially increase the likelihood of unintended consequences and abuse, absent the adoption or extension of appropriate legislative and administrative provisions. With reference to the types of issues illustrated in the above Examples, we believe it will be easier to design administrable rules to prevent inappropriate "streaming" and "dividend stripping" transactions than it will be to design rules to address the types of transactions where a basis reduction or loss limitation rule might theoretically be appropriate. We will highlight these differences as we discuss a number of the related issues in somewhat more detail below.

Issues

1. Retained Earnings Basis Adjustments ("REBAs")

The REBA concept is probably more easily recognized when the terms "dividend reinvestment plan" or "DRIP" are used. Treasury currently proposes that as "an alternative to distributing excludable dividends, corporations will be permitted to allocate throughout the year all or a portion of their EDA to increase their shareholders' basis in their stock."[7] Treasury also proposes that actual corporate distributions in excess of EDA balances will first be allocated, as a return of basis, to cumulative REBAs (i.e., "CREBAs"). The net effect of these proposals will be (i) to permit otherwise undistributed after-tax corporate earnings to be treated as deemed distributions followed by deemed reinvestments by shareholders so as to increase the adjusted tax bases of shareholders' stock and (ii) to permit actual later distributions of those after-tax corporate earnings to be treated as returns of basis to the respective shareholders.

Discussion. Essentially, the REBA and CREBA methodology represents a form of a basis reduction rule that, depending upon how it is implemented, could address the types of issues illustrated in the Basis Reduction Example. Failure to

7 January 21, 2003 Treasury advance release of "Green Book" language re the Dividend Exclusion proposal.

adjust a shareholder's tax basis by the appropriate amounts of undistributed EDA could lead to tax-motivated behavior involving the types of purchase and sale transactions illustrated in that example, with the potential for undesirable tax consequences. Originally, Treasury proposed that REBAs be mandatory, to the extent of undistributed EDAs as of the end of a taxable year, with the adjustments to be made as of December 31 of each year. The Green Book language would permit corporations to allocate REBAs throughout the year, provided that all unallocated EDA balances were allocated as of the end of each year. The Bill language, however, would not require all unallocated EDA balances to be fully allocated by year end. Rather, proposed new Section 282(d) would permit Treasury, by regulation, to authorize EDA balances in later years to be increased by unallocated EDA balances as of the end of a year.

Although the exact REBA and CREBA methodology will require refinement, the basic allocation approach recognizes that a corporation's pool of shareholders may not remain static throughout a given year. If it were possible to adjust a shareholder's tax basis in its shares at the time of a stock sale by the appropriate amount of presale REBAs, it would be possible to avoid some of the undesirable tax consequences illustrated in the <u>Basis Reduction Example</u>, at least to the extent of the attributed amounts. Unfortunately, however, for most corporations other than the closely-held, it will not be possible in practice precisely to correlate REBAs and CREBAs with the timing of actual stock sales and purchases. Hence, it is likely that it will also be necessary for Treasury to consider more generic approaches, such as the adoption of basis adjustment rules modeled along the lines of Section 1059. In this regard, there are a number of related points to consider:

a. Importance of Buyer and Seller Tax Status

The potential to eliminate the effect of the corporate-level tax illustrated in the Basis Reduction Example is primarily a function of the fact that the Seller (C) is a tax exempt entity and the Buyer (D) is a taxpayer that can use capital losses. If the taxable status of the parties had been reversed, the potential for double taxation, rather than zero taxation, would be presented. Moreover, if the Seller and the Buyer were both taxpayers with the same effective tax rates, in theory the loss available to the Buyer, to the extent able to be utilized, would tend to match the overtaxation of the Seller. Consequently, to provide for an automatic basis reduction rule for Buyers, without regard to whether the Sellers are or are not taxpayers, could tend to increase the likelihood of overtaxation of Sellers, thereby raising the question of when, if at all, relief for Sellers would be appropriate. It is readily appreciated, however, that if this issue were left "unaddressed," taxpayers would be much more likely to structure transactions to accomplish the zero taxation, rather than the double taxation, result.

The Bills propose an automatic basis reduction rule for Buyers and would extend the application of Section 1059 to individual taxpayers. Proposed new Section 1059(g) would, subject to such exceptions as are provided by regulations, treat all excludable dividends and REBAs as extraordinary dividends without regard to the amount thereof. In addition, the holding period requirement in respect of such extraordinary dividends would be more than one year, rather than the more than two year period for other extraordinary dividends. While this proposal would tend to address the problem identified herein of eliminating the effect of the corporate-level tax, it would also, absent regulatory relief, contribute to the incidence of double taxation in the cases mentioned above.

b. Method for Allocating REBAs Throughout Year

Under the current formulation for calculating EDA, it appears that a corporation will know on January 1 of each year exactly what its EDA balance will be for that year. Unfortunately, however, although a corporation will know the amount of its EDA, most public corporations will not know at the beginning of a year, or even until the latter part of a year, exactly what their actual dividend payouts will be for the year. Accordingly, unless the corporation has a fixed dividend policy or determines that it will not pay any dividends, it will not be possible to know in advance the actual REBA balance, if any, for the year. Thus, in many instances it would be impossible to develop a rule permitting proration of a specific REBA amount evenly throughout the year, other than on a retroactive basis. Nevertheless, once it is known whether an unallocated EDA balance exists for the year and its amount, there would appear to be at least two possible approaches available for allocating REBAs: (i) permitting corporations some discretion in how the REBAs are to be allocated (discussed in the next section of this Report) or (ii) requiring corporations to adopt nondiscretionary rules for REBA allocations.[8]

[8] The Bills propose to give corporations wide discretion to allocate REBAs among multiple classes of stock at any number of times during the calendar year.

Any approach ultimately adopted to address the allocation of REBAs will introduce some practical and administrative difficulties, particularly when applied in a public corporation setting.[9] Nevertheless, to the extent a nondiscretionary approach is adopted, consideration could be given to allocating REBAs on a pro rata basis throughout the year and attributing them to shareholders, after the end of the year, based on the number of days shares are held during the year. In the context of corporations with multiple classes of stock, consideration also could be given to allocating REBAs proportionately among the different classes of stock on the basis of how actual distributions would have been received during the year.[10] Consideration also could be given to combining a proportional allocation method with a basis reduction rule targeted at "preacquisition earnings." Whatever approach is ultimately adopted, it is likely that there will be increased communications

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9 For example, whatever approach is adopted for allocating REBAs, subsequent year distributions in excess of then current year EDA balances will be treated first as CREBAs (i.e., as actual distributions of prior year undistributed after-tax earnings) and will be so treated to the actual shareholders at the time, irrespective of whether the recipient shareholders are the same shareholders that received the original REBA adjustments and whether the tax bases in the shares of the then current shareholders do or do not adequately reflect prior REBA adjustments. It might be desirable for any holding period requirements adopted as part of any basis reduction rules to be correlated with the allocation rules for REBAs, which could be a particularly complex process if REBAs are required to be allocated on some kind of daily basis throughout the year. The Bills, by proposing an automatic one-year holding period under new Section 1059(g), eschew such an approach in favor of one reflecting a simplifying assumption.

10 We note that Treasury proposes that REBAs not be permitted to be allocated to preferred stock, at least not in amounts in excess of dividend arrearages. The Bills also would preclude allocation of REBAs to preferred stock. This position could be justified on the basis that undistributed after-tax earnings should not be allocated to classes of stock (e.g., fixed liquidation preference preferred stock) not otherwise entitled to receive actual distributions of earnings in excess of prescribed annual dividend levels.

throughout the year by corporations to shareholders as to their EDA balances, expected dividend payouts and REBAs.

c. Permitting Corporate Discretion in Allocating REBAs

Although Treasury currently contemplates permitting corporations to allocate throughout the year all or a portion of their EDA balances to increase shareholders' bases in their stock, it is not exactly clear what discretion is to be permitted corporations in allocating EDA balances during each taxable year. As indicated above, however, the Bill language would provide corporations with wide discretion concerning such allocations. It should be recognized that the more discretion corporations are granted to allocate REBAs, the more likely it will be that inappropriate tax-motivated transactions will be structured and implemented, particularly in the context of closely-held corporations. Any grant of discretion, therefore, should be accompanied by the adoption of appropriate anti-abuse rules.

In this regard, if the discretion accorded corporations in allocating REBAs were to be narrowed, the following approaches could be considered: Corporations could be given discretion to allocate specific amounts of REBAs (i) to particular dates during the year when actual dividends are to be paid or (ii) to particular dates during the year, whether or not connected with dates on which actual dividends are to be paid. Otherwise unallocated amounts (assuming mandatory year-end allocation) could be allocated pursuant to a default rule, such as on a pro rata basis throughout the year. Permitting at least some form of discretion might be particularly suitable for those corporations with relatively fixed dividend or nondividend policies. In either of the above cases, procedures could be implemented pursuant to which shareholders would have some advance notice of how specific amounts of REBAs would be allocated, thereby permitting them to make use of such information, relevant to the calculation of taxable gain or loss, in trading shares of stock during the year.

d. Closely-Held versus Public Corporations

To some extent, these REBA issues are easier to conceptualize when thinking of closely-held corporations. The Basis Reduction Example highlights a type of transaction that, absent application of some kind of basis reduction or EDA allocation rule, would permit objectionable tax outcomes. It is questionable whether the same level of concern should exist for typical fact patterns involving public corporations with thousands of individual shareholders. It would be somewhat difficult to imagine, for example, that the average individual public shareholder would engage in tax-motivated trading of shares merely to take advantage of permissive gaps in the tax rules that otherwise might be adopted to prevent the types of abuse illustrated by the Basis Reduction Example.

With due consideration to the following factors as they might apply to particular shareholders: (i) the dollar value of the REBAs at stake at any point in time, (ii) the number of shares that would have to be acquired in order for the tax consequences associated with any particular transaction to have economic significance, (iii) the difficulties that could be expected to arise in a public corporation setting with a diverse shareholder base, consisting of taxable and tax exempt shareholders, of accomplishing the pricing objectives necessary to accomplish the desired tax arbitrage, and (iv) the potential administrative difficulties associated with applying detailed basis adjustment or EDA/REBA-type allocation methods to all shareholders of public corporations, Treasury reasonably might conclude that particular EDA/REBA-type allocation or related basis reduction rules would best be applied to typical shareholder situations involving public corporations only on an exception basis or only in circumstances where specified conditions for application of a suitable anti-abuse rule were found to exist. Without intending to understate the potential for tax abuse in a public corporation setting, we do think it may be worthwhile to consider developing less burdensome rules for application in public settings (e.g., general safe harbors from any proposed extension of Section 1059 for small shareholdings), as contrasted to the more closely-held corporate setting where the need for appropriate basis adjustment or EDA/REBA-type allocation rules would seem to be essential.

2. Built-In Gain Assets and the Need for Basis Adjustments

The above Basis Reduction Example illustrates that tax reduction opportunities will exist where there is unrealized appreciation in corporate assets, not just in situations where recognized after-tax earnings exist at the time of stock sale/purchase transactions. The first type of fact pattern, relating to built-in gain assets, raises essentially the same type of issue presented in the second type, but in practice is likely to be more difficult to address in an easily administrable manner, particularly for large publicly-traded corporations.

a. The Meaning of "Preaquisition Earnings"

The term "built-in gain" assets is a label we use to refer to many different fact patterns, all of which are characterized by corporations with some form of economic income, whether represented by appreciated assets with unrealized gains or otherwise, that at the time of a shareholder stock sale/purchase transaction is unrecognized for tax purposes. To what extent should these "built-in gains" be treated as "preacquisition" earnings in stock sale/purchase transactions, at least for purposes of attributing the amounts to purchasers, either to permit basis reduction computations or otherwise?

b. <u>Closely-Held versus Public Corporations</u>

As a conceptual matter, properly crafted basis reduction rules patterned after Section 1059 and specific "seller relief" provisions could prevent inappropriate tax reduction opportunities and the incidence of double taxation. As discussed above, it is possible to envision how those rules might operate in the closely-held corporation environment, whether exclusively in the context of REBAs or more broadly with reference to built-in gain assets. In a publicly-traded corporation setting, however, especially difficult practical issues would arise in the context of built-in gain assets relating to how to address the timing of adjustments, the valuation of the corporation's assets, information reporting to shareholders, the realities of street-name registration of share ownership and other similar issues that would severely challenge any efforts to fashion administrable basis adjustment or loss limitation-type rules for all shareholders. In this context, and with due regard to issues of administrability, consideration could be given to the adoption of basis adjustment, loss limitation or similar rules that would be applicable only to large shareholdings or large transactions. Such an approach might be combined with a more broadly applicable anti-abuse rule targeted to transactions involving some identified matrix of telltale circumstances reflective of transactions either structured to achieve or known to produce inappropriate tax results. As indicated above, the Bills propose adoption of an automatic basis reduction rule that would not at all be tailored to likely variations in the underlying fact patterns.

3. Streaming Transactions

Following enactment of the Dividend Exclusion proposal, there will be significant natural tendencies in the marketplace for corporations to "stream" excludable dividends to taxable shareholders and to "stream" capital transactions to tax exempt shareholders, in part to achieve the types of tax consequences illustrated in the above Streaming Example. For example, we anticipate that taxable owners of closely-held corporations will structure redemption transactions more frequently to qualify as essentially equivalent to dividends under Section 302 of the Code. As a result, Treasury should definitely develop rules to prevent "streaming", at least to the extent necessary to prevent inappropriate tax results. Several existing Code provisions are already designed, in part, to prevent streaming-type transactions. In this regard, we note with approval that the current Treasury proposal would retain Sections 304, 305 and 306 and would reduce a corporation's EDA and REBA/CREBA balances by distributions characterized as dividends under those provisions.

a. Redemptions

The above Streaming Example illustrates how redemption transactions could be used to "stream" disproportionate amounts of EDA to taxable shareholders. Both the Treasury proposal and the Bills contain a rule that would be responsive to the abuse potential in that example. The rule provides that corporate distributions to which Section 301 does not apply (e.g., redemptions treated as sales or exchanges of stock) will reduce pro rata the redeeming corporation's current year EDA and CREBA. As applied to the Streaming Example, the rule would have the effect of causing the redemption transaction with shareholder B to reduce Corporation X's $100 EDA balance by $50. That reduction of Corporation X's EDA balance would remove the streaming advantages otherwise available to shareholder A presented by the example.

Treasury has also acknowledged that it will be necessary to modify the attribution rules currently in effect for determining whether a redemption transaction is properly characterized as a dividend or as a sale or exchange. Under current law, it is difficult, and in many cases impossible, for a public corporation to know, in fact, whether a redemption transaction is properly characterized as a dividend or as a sale or exchange. Nevertheless, in an effort to make the Dividend Exclusion rules more administrable and to provide greater certainty as to their application, it would be appropriate to permit redeeming public corporations to make certain assumptions, absent actual knowledge to the contrary, about such things as the application of the attribution rules, at least with respect to the allocation of EDA and REBA/CREBA balances.

b. Multiple Classes of Stock

As discussed earlier in the context of allocating REBAs, we believe it will be necessary to develop sophisticated rules to allocate EDA balances and REBAs for corporate groups with complicated capital structures and multiple classes of stock.

The Bills propose a strict pro rata rule for allocation of EDA and, except as otherwise provided by regulation, would allocate REBAs in the same manner as if cash had been paid as dividends. In this regard, however, we are not certain that a strict pro rata rule is necessarily the most appropriate rule for allocating EDA among multiple classes of stock. Although a general pro rata rule would tend to deter inappropriate efforts to stream excludable dividends exclusively to taxable investors, it also might unnecessarily impede legitimate corporate finance transactions. Consideration should be given to adopting alternative rules for allocating a corporation's EDA, or exceptions to an otherwise applicable pro rata rule, to accommodate nontax-motivated capital market transactions.

For example, fixed liquidation preference preferred stock has been and likely will continue to be an important capital market instrument issued by corporations. Under the current dividends-received deduction regime, it has been considered reasonably important, from a pricing perspective, for the issuing corporation to be able to express some comfort that it will be possessed of sufficient earnings and profits so that all distributions on the preferred stock will qualify as dividends. If the Dividend Exclusion proposal is adopted, corporate issuers of preferred stock will have an incentive to ensure, to the extent possible, that all distributions on such preferred stock will qualify as excludable dividends. To the extent a rule is adopted that a corporation's EDA will be allocated among the corporation's multiple classes of stock on a pro rata basis, with reference to actual distributions on all the corporation's stock interests, the corporate issuer's ability to issue preferred stock that can be favorably priced will be constrained. Such a rule could, therefore, have a significant negative impact on the marketplace for preferred stock. We believe it should be possible to design EDA allocation rules that will accommodate appropriate corporate finance transactions and at the same time deter inappropriate streaming transactions.[11] For example, Treasury could consider a rule that would permit EDA to be allocated first to preferred stock to the extent of distributions thereon.

4. Dividend Stripping - Section 246-type Provisions

Section 246(c) of the Code currently operates to prevent certain "dividend stripping" arbitrage transactions by corporations. Section 246(c) is designed to prevent corporate taxpayers from purchasing stock eligible for the dividends received deduction just prior to a dividend record date, with the purchase price for the stock reflecting an amount approximating the dividend, and then selling the stock just after the record date, when the price of the stock is expected to be lower by at least the amount of the dividend. Section 246(c) operates to prevent corporate purchasers from earning dividend income taxable at a 10.5% rate and claiming a comparable capital loss offsetable in full against capital gain income taxable at a 35% rate. Treasury's current proposal would expand Section 246(c) to cover excludable dividend transactions entered into by corporate, individual and other purchasers eligible for the receipt of excludable dividends.

11 Another impediment to the issuance of preferred stock contained in the Treasury proposal is the requirement that all unallocated EDA be allocated by the end of each year. The Bills, however, propose to give Treasury regulatory authority to permit the carryover of unallocated EDA balances to subsequent years. Exercise of such authority, combined with exceptions to a strict pro rata rule, could permit corporations more predictability in the payment of excludable dividends on preferred stock.

The Bills address this issue, not by proposing to expand the scope of Section 246(c) to cover it, but rather by proposing to reduce the basis of the purchaser's shares by the amount of the dividend in circumstances where the holding period rules of Section 246(c) have not been satisfied. This approach may need reconsideration, however, primarily because the basis reduction result would already be accomplished by proposed new Section 1059(g) (described above).

Discussion: There are various transactions that, for convenience, can be grouped under the heading "dividend stripping" transactions. With reference to excludable dividends, the objectionable transactions could be expected to share certain common elements - typically the combination of an excludable dividend with a corresponding loss transaction. Another similar transaction would be the issuance of preferred stock at a premium issue price due to the presence of an above-market dividend rate, a transaction that would combine an excludable dividend with a corresponding loss, though the time elapsed between the two steps may not be as short as in the more traditional arbitrage transaction. Section 1059(f) was enacted to address such transactions. Because there are a number of other similar transactions to which the specific provisions of Section 246 or 1059 may not be directly applicable, it may be appropriate in this situation to consider adoption of an anti-abuse rule targeted at particular types of transactions that seek to combine excludable dividend income with corresponding loss recognition. Moreover, depending upon what rules ultimately are adopted to govern the allocation of EDA/REBA balances, it may also be necessary to consider imposing different length holding periods (e.g., longer holding periods for disproportionately larger dividends) depending on the aggregate size or proportionate amounts of EDA/ REBAs allocated to particular dates and/or dividends. Subject to the application of appropriate anti-abuse rules, consideration also might be given to adopting certain safe harbors for small shareholdings, as an alternative to applying minimum holding period-type rules to millions of individual shareholders.

5. <u>Dividend Stripping - Section 246A/265-type Provisions</u>

Section 265 of the Code denies a deduction for interest expense on debt "incurred or continued to purchase or carry" certain debt that pays interest income exempt from tax. Section 246A accomplishes a similar result by limiting the amount of dividends eligible for the dividends received deduction, in connection with certain debt-financed purchases of preferred stock. Section 163(d) limits the deduction individuals can claim for investment interest expense to net investment income.

Treasury currently proposes to extend the application of Section 246A to limit the ability of corporate, but not individual, investors to claim excludable dividend treatment in circumstances where debt is incurred to purchase the underlying stock.[12] In addition, Treasury proposes that excludable dividends not qualify as investment income eligible to be offset by investment interest expense for purposes of Section 163(d).

[12] On February 3, 2003, Treasury announced a modification to its original proposal. As modified, the proposal would exclude individual investors from the application of amended Section 246A. The Bills also reflect this revised proposal (i.e., new Section 286(d)).

Discussion: This is a complex topic that can be analyzed from a number of different perspectives. A few of those perspectives and some practical implementation issues are described below:

a. 1992 Treasury Legislative Recommendations

In its 1992 legislative recommendations, Treasury recommended (i) that Section 246A/265-type provisions not apply to corporate or individual taxpayers in respect of debt incurred to purchase stock that paid excludable dividends and (ii) that excludable dividends not qualify as investment income for purposes of Section 163(d). At the time, Treasury stated that those recommendations were consistent with its decision "not to recommend modifications to the rules governing debt, and [its] policy bias against rules that are complex and difficult to administer."[13] The reference to not recommending modifications to the "rules governing debt," relates to the fact that, in 1992, Treasury did not recommend changing the rules permitting corporations to incur tax-deductible interest on borrowings from tax exempt lenders, a practice that had the effect then and continues to have the effect today of eliminating all tax on corporate income, to the extent of the tax-deductible interest expense.

From Treasury's perspective at the time, permitting tax-deductible borrowings to finance purchases of corporate equity would produce tax results no worse than those associated with corporations borrowing from tax exempt lenders, a form of "rate arbitrage" that would continue to be available as a matter of US tax

13 See Treasury Recommendation, supra, footnote 2.

policy. Moreover, Treasury believed that permitting individual taxpayers to deduct interest incurred on debt used to acquire corporate equity against other non-dividend investment income would not be inconsistent with then current law provisions (i.e., Section 163(d)) permitting taxpayers to deduct "investment interest expense." Hence, Treasury did not think it was necessary separately to confront the complexity and difficulty of implementing more specific interest disallowance rules at the shareholder level.

b. Alternative Defense of Treasury's Current Position

An alternative defense of the position that a Section 246A-type provision should not be imposed to limit the ability of investors to claim excludable dividend treatment in circumstances where debt is incurred to purchase the underlying stock is predicated on the view that the fundamental objective of the Dividend Exclusion proposal is to impose only one tax, at either the individual or corporate level, on income from all "net equity capital" held by US investors. From this perspective, because the use of leverage does not produce any increase in the amount of "net equity capital", there should be no net increase in US tax. Thus, in circumstances where income derived by corporations from the investment of equity capital would, absent the presence of tax preferences, produce an increase in US tax at the corporate level, an excessive amount of US tax would be imposed on a combined basis unless shareholders were permitted tax deductions for interest incurred to borrow amounts supplied to corporations as equity capital. We note that this argument would appear to apply equally to debt incurred by corporate investors to acquire portfolio stock.

The above situation is to be distinguished from the situation where a taxpayer is denied the ability to deduct interest on borrowings to acquire debt issued by a municipality, the interest on which debt is exempt from US tax (i.e., Section 265). In the latter situation, because the municipality is not subject to US tax and hence not even a single level of tax is imposed in the first instance, a net deduction could result to the extent an interest disallowance provision is not imposed.

c. Rate Arbitrage Concerns

Another perspective on this topic, and one alluded to by Treasury in its 1992 Report, suggests that permitting rate arbitrage, particularly of the type exhibited by individual shareholders borrowing from tax exempt lenders to fund the purchase of corporate equity, could, in the extreme and without other applicable limitations, have the effect of eliminating the effective incidence of the additional corporate-level tax imposed on the income derived from invested equity capital formally supplied by individual shareholders. In 1992, for example, in connection with one of the alternative integration proposals (i.e., the "CBIT"[14] proposal), that had as its central feature imposition of a single level of tax on corporate earnings, Treasury did recommend the adoption of interest disallowance provisions, motivated by a concern that failing to do so would tend, through the incidence of rate arbitrage transactions, to undermine the imposition of even that single level of tax.

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14 Pursuant to the CBIT (Comprehensive Business Income Tax) proposal, corporations would have been permitted no deductions for interest expense or dividend payments, but both interest and dividend income would have been exempt from tax at the shareholder level.

The above concern would be most directly present in circumstances where individuals are used as conduits, borrowing funds from tax exempt entities to supply equity capital to corporations. Recognizing that there is a vast reservoir of capital able to be supplied to corporations by tax exempt entities,[15] in extreme cases, and absent application of specific limitation provisions, there would be few practical limits to the use of leverage to eliminate the single level of US tax intended to be imposed on corporate income.[16] Under present law, however, the investment interest rules, at least with respect to individual taxpayers, generally would apply to foreclose application of the extreme conditions suggested above, primarily because Congress has limited the deduction for interest expense to an individual's net investment income. Even in this context, however, there is a concern that permitting deductions for interest expense on debt incurred to acquire corporate equity paying excludable dividends could inappropriately enhance the ability of taxpayers to offset their other investment income with interest expense. A much greater concern would be present to the extent excludable dividends were permitted to be included as investment income for this purpose. In such a case, the extreme conditions suggested above actually could materialize, because it would then be possible for

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15 For this purpose, a tax exempt entity could be a US tax exempt entity such as a pension fund or a non-US person exempt from US tax on interest income.

16 Fashioning a remedy to address this concern, however, would involve its own degree of complexity and practical difficulties. For example, we note that the application of interest disallowance provisions in circumstances where the lenders are taxpayers would result in the incidence of double taxation, not the single level of tax intended by the Dividend Exclusion proposal.

interest expense to be deductible against non-investment income, thereby fundamentally expanding the scope of the rate arbitrage potential.[17]

d. Practical Implementation Issues

(i) Earnings Stripping Rules Even if Treasury maintains its current position of not proposing to extend a Section 246A-type provision to individuals, it will be important to consider whether changes should be made in the earnings stripping provisions contained in Section 163(j), and perhaps other similar provisions, where restrictions exist under current law on deducting interest at the corporate level, but not at the individual shareholder level. For example, if a tax-exempt person (a non-US person entitled to treaty benefits or a domestic tax exempt institution) owns more than 50% of the stock of a US corporation, the US corporation would not be permitted to deduct interest on a loan from such exempt person, to the extent the provisions of Section 163(j) otherwise applied. Treasury should assess whether the tax policies reflected in Section 163(j) would be undermined to the extent the exempt person instead made loans to US individuals who in turn invested in stock of the US corporation. To the extent permitting interest deductions to individual shareholders in conduit-type situations would be perceived as violating the tax policies underlying Section 163(j), regulations could be adopted to prevent such abuse. Alternatively, to the extent permitting interest deductions to individuals, provided they were subject to existing "investment interest" limitations, would not be perceived as inconsistent

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[17] We note the Bills propose that excludable dividends not be includable in gross income, with the result that such dividends would not be capable of being considered as investment income.

with preexisting tax policies, then either no amendments would be required or alternatively amendments could be made to Section 163(d) and/or other provisions to prevent abusive conduit-type transactions.

(ii) Application of Section 246A/265-type Rules to Corporate Shareholders We understand Treasury is considering whether also to exempt corporations from the application of a Section 246A-type provision in circumstances where they incur debt to acquire stock paying excludable dividends. The Bills propose to apply Section 246A to corporate shareholders. As a matter of principle, generally we believe it is difficult to justify different treatment of individuals and corporations for purposes of the application or nonapplication of Section 246A in such circumstances. There is one perspective, however, from which it might be argued that different treatment is justifiable. For those who believe the investment interest restrictions of 163(d) appropriately limit the extent of permissible rate arbitrage, the absence of comparable rules applicable to corporations would tend to support restricting the ability of corporations to engage in unlimited rate arbitrage. Others might argue that even in this situation, the otherwise limiting effects of traditional debt/equity principles would obviate the need for a special Section 246A-type limitation applicable to corporations.

(iii) Complexity If, upon reflection, Treasury decides to propose a Section 246A/265-type rule with respect to excludable dividends, it should not underestimate the complexity likely to be associated with the rule and the difficulties likely to be associated with implementing it. In such a circumstance, Treasury should draw upon the practical experience of the Internal Revenue Service over the last several decades in administering Sections 246A and 265 and a serious attempt should be made to develop rules that would not impose significant administrative burdens on taxpayers or the IRS, even if that were to mean adoption of a less precise disallowance rule than is represented by current law provisions. The fundamental difficulty with certain of the existing rules is that, with some ability to engage in advance planning, taxpayers are reasonably adept at structuring their affairs so that they do not incur specific indebtedness to acquire prohibited property and do not pledge such property for the repayment of particular indebtedness. It is just such behavior that has led to the adoption in Section 265, for example, of pro rata rules to facilitate a more administrable disallowance mechanism in circumstances where taxpayers have, in fact, incurred indebtedness and do, in fact, own tax exempt bonds.

The practical difficulties likely to be associated with applying a pro rata rule to millions of individual shareholders, however, even with the recognition that similar rules may already technically apply with respect to investments in tax exempt bonds, could be substantial. Recognizing this, Treasury could consider, as an alternative, the adoption of Section 246A/265-type disallowance rules that would apply generally to all taxpayers, but only in combination with (i) the adoption of safe harbors based either on dollar levels of dividend income, dollar size of borrowings or other factors, and (ii) the adoption of appropriate anti-abuse rules.[18]

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18 If Treasury ultimately does not propose a Section 246A/265-type rule, it nonetheless should be sensitive to the appearance concerns and the financial marketplace pricing impacts of continuing to impose interest disallowance provisions with respect to borrowings to acquire tax exempt bonds while at the same time imposing less restrictive provisions (e.g., Section 163(d)) with respect to borrowings to acquire stocks that will pay excludable dividends.

6. Excludable Dividend Amount ("EDA") Calculation

The items required to be included in EDA calculations will directly affect the degree to which the Dividend Exclusion proposal accomplishes the stated objective of eliminating double taxation of corporate earnings. In this regard, the issue arises as to whether EDA will be calculated so as to include explicit Congressional tax preferences (e.g., municipal bond income exempt under Section 103 of the Code); and if so, which ones and to what extent.

Discussion: In 1992, Treasury recommended that certain interest income exempt from tax under Section 103 and percentage depletion in excess of basis increase EDA. That recommendation reflected a policy to preserve at the shareholder level permanent exemptions contained in explicit Code provisions. Failure to incorporate similar provisions in the current proposal will have the effect, in respect of preference items recognized at the corporate level, of diluting the tax effect of the preference item. For example, to the extent a corporation is able to exclude tax exempt interest under Section 103 from its taxable income, but such excluded amount will not be included in EDA, the inevitable effect will be to impose tax on such income at the shareholder level, recognizing that corporate distributions in excess of EDA/CREBA balances generally will be taxable to taxable shareholders. As part of its Dividend Exclusion proposal, Treasury may decide to exclude all so-called permanent preference items from the EDA calculations and, as an alternative, take those issues up as a separate matter at a subsequent time after adoption of the basic dividend exclusion mechanism following a comprehensive review of the existing tax preference items in the Code and an analysis of which, if any, of them should be preserved at the shareholder level.

7. EDA - Limitation on Net Operating Loss ("NOL") Carrybacks

A fundamental objective of the Dividend Exclusion proposal is to ensure that the distribution of corporate earnings that have been subjected to full corporate-level tax will not be taxed again at the shareholder level. Once a taxable year has ended, EDA with respect to such year has been calculated and the time for accounting for actual and deemed distributions of EDA has passed, the question arises whether losses derived in subsequent years should be permitted to be carried back to prior years to permit the refund of prior taxes, as under current law.

Discussion: In its 1992 legislative recommendation, Treasury proposed that NOL carrybacks be eliminated, primarily on the basis that it would be too difficult, administratively, to implement an equitable mechanism to implement the refund of prior taxes. Because one of the effects of permitting the refund of prior taxes via a NOL carryback mechanism would be to recharacterize prior excludable distributions to shareholders as taxable, practical issues obviously would arise as to how feasible it would be, after the fact, to implement procedures to collect additional taxes in later years from shareholders with respect to distributions originally reported to them as excludable in prior years.

We understand Treasury currently proposes to permit NOL carrybacks to the immediately prior taxable year, but any such carrybacks will require adjustments in the EDA calculation for the current taxable year. For example, and assuming a calendar year corporate taxpayer, if during 2004 it became clear that there had been a

NOL for the 2003 taxable year, the new rules would permit that NOL to be carried back to the 2002 taxable year. But because the tax for the 2002 taxable year is the tax that is used in determining EDA for 2004, any such carryback would, in the first instance, require a reduction in the 2004 EDA balance. To the extent the 2004 EDA balance is reduced to zero, any further "refunds" would instead be credited against future tax liability. This approach certainly would avoid the significant practical difficulties, highlighted above, associated with permitting NOL carrybacks to years earlier than the immediately prior taxable year.

8. EDA - Consolidated Return Issues

We understand that EDA will be calculated on a consolidated basis for affiliated groups filing consolidated tax returns. The Bills propose to give Treasury explicit regulatory authority to address consolidated return issues of the type described below. (See proposed new Section 287).

a. Stock Issued By Lower-tier Subsidiaries

Many public corporate groups not only issue multiple classes of stock (both common and preferred) to outside investors, but also have multiple issuers within the group. Under current law, the primary focal point with respect to assessing dividend status on stock has been to determine whether the corporate distributions have been made out of "earnings and profits". Under a Dividend Exclusion regime, however, the EDA concept will take on at least as much importance as "earnings and profits", particularly for preferred stock that is intentionally structured to provide excludable dividends. Thus, specific Treasury/IRS guidance will be required for allocating EDA balances among the distributions on different classes of stock issued by affiliated group members, including those classes of stock issued to outside investors by lower-tier subsidiaries.

b. Tracking Affiliated Group EDA Balances

The tracking of EDA balances within affiliated groups is analogous to the tracking of "franking" in certain other jurisdictions with integration-type corporate tax systems (e.g., Australia). This is a topic that has proven to be rather complex in other jurisdictions and likely will require the development of specific ordering or Astacking@ rules. It will be necessary to determine exactly how EDA balances will be permitted to move up a chain of corporations within an affiliated group. For example, if a lower tier subsidiary receives an excludable dividend from an unrelated corporation, will an amount equal to the excludable dividend be added to the affiliated group's EDA balance, thereby permitting the parent of the group to pay excludable dividends to its shareholders, even in situations where the recipient subsidiary is otherwise in a substantial loss position and would not be able to pay dividends itself? Separately, what limitations, if any, should be imposed on a corporate group's ability to "acquire" EDA balances, so to speak, from outside the affiliated group and what portion, if any, of the group's EDA balances should be allocated to members leaving the group?

9. Trafficking in CREBAs

Although Treasury proposes that "Section 269 will apply, as under current law, to discourage tax-motivated acquisitions, including acquisitions undertaken for the purpose of obtaining an EDA or a CREBA", it does not propose any Section 382-

type rules to address EDA balances, primarily on the basis that EDA balances will expire at the end of each year.

Discussion: For many corporations that actually distribute only small portions of their after-tax earnings, it is possible that very substantial CREBAs could accumulate over time. Substantial CREBAs possessed by a target corporation could be attractive to an acquiring corporation that, itself, has relatively small or nonexistent CREBAs, but prefers to make return of basis distributions rather than taxable dividend distributions to its shareholders. From this perspective, Treasury should give consideration to strengthening the provisions of Section 269 and expanding Section 382 to include CREBAs. The Bills propose to extend the application of Section 381 to permit the carryover of EDA and CREBAs in tax-free acquisitions, but are silent as to the application to taxable stock acquisitions.

10. Abuse of Corporate Form

To the extent the Dividend Exclusion proposal is enacted, taxpayers might have increased incentives to make use of the corporate form to minimize after-tax returns. For example, to the extent existing businesses are currently structured as sole proprietorships, S corporations or partnerships, it might be advantageous for some of these businesses to incorporate, to incur lower rates of corporate tax on business income and then have the corporations pay excludable dividends of much of the after-tax earnings to the shareholders. In addition, it might be possible for certain personal service businesses that currently report all their income as subject to FICA, to incorporate the businesses, have the corporations pay reduced levels of FICA-eligible compensation to the owners and then have the corporations pay after-tax earnings of the newly-incorporated businesses as excludable dividends to the shareholders. There also will be other situations where the use of the corporate form could permit taxpayers to engage in inappropriate arbitrage transactions, whether involving rate differentials or otherwise. As part of its implementation of the Dividend Exclusion proposal, Treasury should develop specific rules to prevent the results in identified situations and an anti-abuse rule to protect against other similar types of transactions.

11. International Provisions - Increase in EDA By Reason of Foreign Taxes Paid

We understand Treasury proposes to permit non-US taxes to be treated the same as US taxes in calculating a corporation's EDA, at least to the extent of non-US taxes actually claimed as foreign tax credits on a filed US tax return.

Discussion: Treasury's current proposal on this issue is consistent with principles of capital export neutrality, in that it extends equal integration benefits to US corporations operating and taxable outside the United States as it does to those US corporations operating only domestically. Nevertheless, it is unusual for a country to extend the benefits of integration to include creditable foreign taxes. Although we have not undertaken a review of the current practices of our major trading partners relating to this question, we do believe it would be important, in balancing the potential revenue loss associated with the current proposal, for Treasury to ensure, prior to implementation, that the unilateral adoption of this proposal would not undermine the ability of the US to achieve adoption of reciprocal-type provisions in other key trading jurisdictions where such provisions do not currently exist.

In addition, there is a concern that permitting non-US taxes to be treated the same as US taxes in calculating a corporation's EDA will lead to inappropriate tax-motivated transactions. US corporations would have increased incentives to engage in foreign tax credit planning designed to engineer the production of foreign taxes that could offset US taxes at both the corporate and shareholder levels. Consideration, therefore, should be given to adopting appropriate anti-abuse rules designed to prevent inappropriate structuring of foreign tax credit transactions.

12. International Provisions - US Corporate Dividends Paid to Non-US Persons

We understand Treasury proposes to treat US corporate dividends paid to non-US persons as fully subject to US withholding taxes, subject to reduction based on applicable treaty provisions.

Although principles of capital import neutrality would support permitting payment of US corporate excludable dividends to non-US persons free of US withholding tax, US tax rules traditionally have given little scope to such principles. Moreover, it is not customary for countries that adopt integration-type systems unilaterally to extend exemptions from source country withholding taxes to dividends paid to nonresidents. Customarily, those countries extend exemptions only based on bilateral treaty negotiations, and only to the extent reciprocal provisions are agreed to by treaty counterparties. Moreover, we understand that, notwithstanding theoretical arguments to the contrary, limiting integration benefits to "domestic" residents generally has not been considered a violation of anti-discrimination provisions contained in bilateral tax treaties, at least not on the basis of positions commonly taken over the years by other countries with integration-type tax systems. These systems regularly subject nonresidents to source country withholding tax on dividends that otherwise would be exempt from local tax if paid to source country residents.

Discussion: To the extent US corporate dividends paid to non-US persons will not be eligible to be treated as excludable dividends, at least two related issues must be addressed. Will actual and deemed dividends (under the REBA provisions) reduce the paying corporation's EDA and REBA/CREBA balances, even though actual dividends will be subject to US tax at the shareholder level in the form of the US dividend withholding taxes? Although in 1992 Treasury recommended that both actual and deemed dividends reduce the corporation's EDA, an opposing argument would be that as long as dividends paid to non-US persons are fully subject to US withholding tax, thereby preserving to that extent the double taxation of dividends, those dividends should not reduce the corporation's EDA or CREBA. To some extent, however, this position could enable corporations, at the price of relatively modest levels of US withholding tax, to design their capital structures so that EDA balances could be "streamed" primarily to taxable investors. Moreover, from a practical perspective, public corporations generally are unable to determine which of their shareholders are non-US persons. Although that information will be known to some participants in the chain of payments between dividend-paying corporation and shareholder, whether it is the intermediary financial institution with which the relevant shareholders maintain their accounts or otherwise, unless that information is readily available to the dividend-paying corporation, it might not be feasible to design rules that depended on the actual status of the shareholders to which dividends are paid. In this regard, arguments would be made that both (i) the negative aspects associated with potential "streaming" transactions and (ii) the practical problems associated with any attempts to provide for different treatment based on the status of the shareholder support a policy of reducing corporate EDA balances by dividends paid to all shareholders.

The combination of reducing a US corporation's EDA by dividends paid to non-US shareholders and subjecting those dividends to US withholding tax, when coupled with the general exemption from US tax for capital gains on sales of shares by non-US persons, is likely to increase the incentives for shares to be sold to taxable US persons, at a minimum, around the time the US corporations make actual dividend payments. The presence of such incentives would tend to underscore the importance of Treasury adopting appropriate basis reduction or holding period rules.

13. <u>International Provisions - Dividends Paid by Non-US Corporations</u>

Treasury proposes to permit non-US corporations to pay excludable dividends. US income taxes on income of a non-US corporation effectively connected with a US trade or business will be treated as US income taxes for purposes of calculating the non-US corporation's EDA. In addition, a non-US corporation's EDA will be increased by excludable dividends and CREBAs that it receives, reduced by any related US withholding taxes.

<u>Discussion</u>: Although Treasury should be commended for proposing to permit non-US corporations to pay excludable dividends, the administrative difficulties likely to be associated with such a proposal would appear to be quite substantial. The proposal will require Treasury to develop comprehensive

procedures applicable to non-US corporate dividend payors - procedures that will permit the IRS to assess the accuracy of written statements to be provided to US shareholders disclosing the portion of the dividends eligible for excludable dividend treatment. Those procedures likely will require the extension of US information reporting-type rules to significant numbers of non-US corporations generally not currently subject to US reporting rules with respect to dividends paid and computation of earnings and profits. Moreover, it is not readily apparent how the IRS would, in practice, be able to ensure compliance with many of the relevant substantive US tax rules. For example, is it reasonable to expect the IRS to be able to determine whether the non-US corporate dividend payors have properly tracked the computations of EDA balances, recognizing that many of the likely payors will be members of large corporate groups with dozens of affiliates, or have otherwise not engaged in transactions that would be in conflict with the excludable dividend provisions applicable to US corporations? One answer to these questions may be that non-US corporations interested in being able to pay excludable dividends will be required to consent to procedures that will permit the IRS to ensure compliance with the applicable US reporting rules.[19] It would not be too surprising, however, to discover that many non-US corporate groups otherwise eligible to apply these rules and thereby pay excludable dividends will choose not to take advantage of the opportunity under those circumstances.

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[19] The Bills propose to give Treasury authority to extend its reporting rules to foreign persons (proposed new Section 287(b)(2)).

14. Anti-Abuse Rules

Enactment of the Dividend Exclusion proposal would effect significant changes in longstanding US tax rules. Notwithstanding the availability of a substantial body of literature on this topic, we do not believe it is possible to anticipate all of the important direct and indirect tax consequences that will flow from enactment. Moreover, it seems reasonably clear that any new legislation on this topic would result in some amount of unintended consequences. Notwithstanding the degree of care taken in drafting the relevant operative statutory language, we believe it also would be advisable to enact appropriate anti-abuse provisions to safeguard the intended operation of the dividend exclusion rules. The Basis Reduction, Streaming and Dividend Stripping Examples set forth at the beginning of this Report highlight three important areas where the presence of targeted anti-abuse rules could be helpful. Anti-abuse rules to address other related topics also are likely to be necessary. Once the specific provisions of the Dividend Exclusion proposal are finalized, we would be pleased to work with Treasury to develop specific statutory/regulatory language.

15. Transition Issues

Transition issues arise anytime a legislative proposal is being considered which, if enacted, would effect significant changes in longstanding US tax rules. One of the more important transition issues associated with the current Dividend Exclusion proposal relates to preferred stock eligible for the dividends received deduction.

A multi-billion dollar marketplace has developed over the years for fixed liquidation preference preferred stock. Much of the preferred stock issued in this marketplace has been issued with the expectation that dividends on the preferred stock would be eligible for the 70/80% dividends received deduction under existing law, where eligible dividend status turns on the availability of corporate earnings and profits, not EDA balances. Enactment of the Dividend Exclusion proposal could have a dramatic effect on the tax consequences and trading prices of existing issues of preferred stock. In 1992, as part of its dividend exclusion proposal, Treasury proposed a transition rule pursuant to which preferred stock would remain eligible for prior law treatment for up to 5 years. The most recent Treasury release and the Bills propose a limited transition rule for preferred stock. It is suggested that Treasury review both the existing marketplace for preferred stock and the prior instances when Congress has adopted grandfathering provisions at the time fundamental legislative changes have been enacted, in order to assess whether the proposed transition rule is appropriate and what, if any, additional transition rules should be proposed for existing preferred stock instruments.