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TAX SECTION

REPORT #523

New York State Bar Association

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Attached letter dated 4/16/86 enclosing Report on Miscellaneous Corporate Provisions of H.R. 3838 sent to the following:

The Honorable Dan Rostenkowski
cc: The Hon. John J. Duncan
Robert J. Leonard, Esq.

The Honorable Bob Packwood
Chairman
Senate Finance Committee
cc: The Hon. Russell B. Long
John Colvin, Esq.

The Honorable David H. Brockway
Chief of Staff
Joint Committee on Taxation

J. Roger Mentz, Esq.
Assistant Secretary (Tax Policy)
United States Treasury

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RICHARD G. COHEN, Chairman, 40 Wall Street, 24th floor, New York City 10005
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April 16, 1986

The Honorable Dan Rostenkowski
2232 Rayburn Building
Washington, DC 20515

Dear Representative Rostenkowski:

I enclose a report of the Tax Section of the New York State Bar Association, commenting on the following miscellaneous corporate provisions of H.R. 3838:

(1) Bill Section 302 - repeal of the corporate capital gains rate;

(2) Bill Section 303 - reduction in the dividends received deduction;

(3) Bill Section 311 - the dividend paid deduction;

(4) Bill Section 312 - reduction in the dividends received deduction;

(5) Bill Section 321(d)(1) - repeal of the "workout" exception of Section 108(e)(10)(C);

(6) Bill Section 1504(e)(1) - amendment to the definition of "affiliated group";

(7) Bill Section 1504(g) - dealing with the overlap between Code sections 337 and 368;

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(8) Bill Section 1504(j) - technical corrections to the Golden Parachute rules;

(9) Bill Section 1505(c)(1) - discussing nonliquidating distributions of partnership interests by corporations;

(10) Bill Section 1575(b) - making certain technical amendments to Code section 304.

I hope that the report's comments on these provisions of H.R. 3838 will prove helpful.

Sincerely,

Richard G. Cohen

Enclosure
cc: The Honorable John J. Duncan) with
Robert J. Leonard, Esq.) enclosure

REPORT #523

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

REPORT ON MISCELLANEOUS CORPORATE PROVISIONS OF H.R. 3838

April 16, 1986

April 16, 1986

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

REPORT ON MISCELLANEOUS CORPORATE PROVISIONS OF H.R. 3838[1]

This report comments on the following provisions of H.R.3838 (the "Bill") relating to taxation of corporations:

I. Bill Section 302 - repeal of the corporate capital gains rate;

II. Bill Section 303 - reduction in the dividends received deduction;

III. Bill Section 311 - the dividend paid deduction;

IV. Bill Section 312 - reduction in the dividends received deduction;

V. Bill Section 321(d)(1) - repeal of the "workout" exception of Section 108(e)(10)(C);

VI. Bill Section 1504(e)(1) - amendment to the definition of "affiliated group";

VII. Bill Section 1504(g) - dealing with the overlap between Code sections 337 and 368;

VIII. Bill Section 1504(j) - technical corrections to the Golden Parachute rules;

IX. Bill Section 1505(c)(1) - discussing nonliquidating distributions of partnership interests by corporations;

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[1] This Report was written by Michael L. Schler and Edward D. Kleinbard, co-chairmen of the Committee on Corporations, with assistance from Matthew Brady, Herbert L. Camp, Michael J. Emont and Arthur L. Kimmelfield. Helpful comments were received from Renato Beghe, Richard G. Cohen, Allen R. Friedman and Stewart J. Stern.

X. Bill Section 1575(b) - making certain technical amendments to Code section 304.

Provisions relating to the repeal of General Utilities, as well as the net operating loss provisions, are discussed in separate reports.

I. <u>Repeal of Corporate Capital Gains Rate.</u>

Section 302 of the Bill eliminates the 28% corporate alternative rate on long term capital gains and taxes net capital gains at the same 36% rate applicable to ordinary income. The repeal generally is effective for gain recognized after December 31, 1985 on sales or exchanges occurring after September 25, 1985 (for which no binding written contract was in effect on that date), except that the rate phases in over four years with respect to gains attributable to timber, iron ore, and coal.

Comments

Whatever the merits of repealing the corporate capital gains rate, we note that the repeal, combined with the repeal of *General Utilities*, will result in a substantially increased level of tax upon a liquidation of a corporation. Under current law, for example, an individual shareholder in a corporation faces a maximum 20% tax upon receiving a distribution in liquidation of the corporation (assuming no corporate level recapture income). Under the Bill, unless an exception to the repeal of *General Utilities* applies, the same distribution will be taxable at a rate in excess of 50%.[2] This result may

[2] For $100 of asset appreciation at the corporate level, the corporation would pay $36 of tax, leaving $64 to be distributed and taxed at the 22% rate for individuals.

unreasonably encourage shareholders of already-formed corporations to maintain the corporation, and might discourage those now starting businesses from selecting the corporate form (unless Subchapter S is available).

The tax burden is even greater to the extent that the liquidating corporation's shareholders are themselves corporations. Under the Bill, for example, a section 331 liquidating distribution of appreciated assets (or a sale of assets followed by a liquidating cash distribution) to a corporate shareholder would result in an effective tax rate on the appreciation in excess of 59%.[3]

We also note that the repeal of the corporate capital gains rate will give corporations a strong incentive to treat all gains and losses as ordinary, because capital gains will no longer have a rate advantage, while corporations still will be prohibited from offsetting an overall capital loss against ordinary income. Individuals, by contrast, will continue to obtain a rate differential advantage by recognizing long-term capital gain rather than ordinary income. This dichotomy may create difficulty in the administration of the tax law

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[3] For $100 of asset appreciation at the corporate level, the corporation would pay $36 of tax, leaving $64 to be distributed and taxed at the 36% rate.

since individuals and corporations that otherwise are similarly situated will have strong incentives to treat identical transactions differently.

II. Reduction in Dividends Received Deduction.

Section 303 of the Bill reduces the dividends received deduction from 85% to 80%. This prevents a reduction in the effective tax rate on intercorporate dividends that otherwise would result from the reduction in the maximum corporate tax rate from 46% to 36%.

The existing maximum rate is 15% of 46%, or 6.9%, and the new maximum rate will be 20% of 36%, or 7.2%. House Report, at 244.

Comments

1. Given the stated purpose of the provision, it is anomalous that the reduced deduction is effective for dividends received or accrued after December 31, 1985, while the reduced tax rates to the recipient corporation are effective for taxable years beginning after July 1, 1986 (with a blended rate for tax years straddling that date). The result is an effective tax rate for dividends received during 1986 by a calendar year corporation of 20% of 41%, or 8.2%. We also note that for taxable years beginning after December 31, 1986, the Bill provides for a small absolute increase (from 6.9% to 7.2%) in the tax on dividends received.

III. Dividend Paid Deduction.

Section 311 of the Bill provides for a new dividend paid deduction. The deduction applies to dividends paid in taxable years beginning after January 1, 1987, and is phased in at the rate of 1% per year for 10 years (i.e., an eventual total of 10% of dividends paid will be deductible).

Dividends eligible for the deduction are those paid out of the qualified dividend account ("QDA"). In general, the QDA begins at zero, is increased by taxable income, is decreased by the deduction equivalent of nonrefundable tax credits, and is further decreased by dividends paid to the extent of the balance in the account at the end of the year.

Comments

1. We recognize the existence of a strong argument for integrating corporate and shareholder level taxes, and believe that a dividend paid deduction may be a proper method to reach that result. However, we do not believe this provision of the Bill is worth the additional complexity it introduces into the Code, given the limited nature of the integration, the delayed effective date of this provision, the very slow phase-in, the flawed nature of the partial integration and the technical intricacy of the changes needed to correct those flaws (as detailed

below). Until a more comprehensive integration scheme can be adopted, we recommend deletion of the entire provision.

2. Under the Bill, the present 100% deduction for dividends received from an 80% nonconsolidated subsidiary is phased down from 100% to 90% for dividends paid out of the subsidiary's qualified dividend account. However, if a controlled subsidiary pays a dividend that exceeds its qualified dividend account, that excess dividend generally qualifies for a 100% dividends received deduction in the hands of the corporate parent. (In effect, then, the Bill adopts for affiliated groups the symmetrical result we propose below for all corporate investors.)

The House Report does not recommend corresponding changes for dividends paid and received in the consolidated return regulations. The consolidated return dividends received deduction presently is slightly broader than the nonconsolidated return 100% dividends received deduction (e.g., dividends received out of pre-acquisition earnings are fully deductible by the recipient only under the consolidated return rules).

We believe the consolidated and nonconsolidated rules for dividends should be as similar as possible. If the provision is adopted in its present form, therefore, we believe that similar rules should be adopted in the consolidated return context.

3. As we noted above, there are a number of flaws in Bill Section 303 which, on the one hand, cause the proposal to fall short of its goal of partial integration and yet, on the other hand, cannot be corrected without adding even greater complexity to an already complex proposal. Most of the flaws result from a discontinuity between the availability (or nonavailability) of the dividend paid deduction to the payor and the availability (or nonavailability) of the dividends received deduction to the payee.

A number of these flaws, together with the changes we believe would be necessary to correct them, are described below. The descriptions should be understood more as evidence of the overly complex and flawed nature of Bill Section 303 (and therefore as a reason to eliminate this Section altogether) than as suggestions of changes to be made in the Bill.

It appears that the QDA can never be negative, and that net operating losses reduce the QDA in the years in which they are utilized as a carryover or carryback. This rule has commendable simplicity. However, we believe an adjustment would be appropriate when a loss carryover or carryback "straddles" the effective date of the provision.

For example, if a calendar year corporation has a loss in 1988 (the first year the provision will be

effective) that is carried back to 1987, and an equal amount of taxable income in 1989, the logical result is that the QDA be zero at the end of 1989 (because aggregate taxable income was zero for all years since the new provision became effective). The Bill is more favorable in this case, giving a QDA at the end of 1989 equal to the full taxable income for 1989.

On the other hand, if the corporation has a loss in 1987 that is carried forward to 1988, logically the 1988 taxable income (unreduced by the carryover) should increase the QDA. The Bill, however, reduces the QDA by the amount of the carryover.

4. Under the Bill, distributions in redemption of stock, in liquidation or in a reorganization are not eligible for the deduction, even if they are taxable as dividends to the recipients under section 301. The rationale for this provision is not clear. To the extent the concern is whipsaw, with the corporation claiming a deduction and the shareholder reporting capital gain, the logical solution would be to condition the corporation's deduction on its filing Forms 1099 reporting dividend income to the shareholders (whether or not such reporting is presently required).

Alternatively, the deduction could be made available only if the distribution is pro rata to all

holders of the same class of stock (regardless of whether such distribution takes the form of a dividend, a redemption or a partial liquidation), thus paralleling Code Section 562(c) which uses this test in determining the availability of the dividends paid deduction to a personal holding company.

5. Under the Bill, a 5%-or-greater tax-exempt shareholder of a corporation is treated as having unrelated business taxable income in the amount of its share of the corporation's dividend paid deduction, generally based on the corporation's return as originally filed. House Report, at 240-41. An argument could be made that the treatment of the tax-exempt shareholder should not depend on the availability to the paying corporation of a dividend paid deduction, just as the availability to a paying corporation of an interest deduction does not depend on whether the interest is taxable income to the payee. On the other hand, it could be argued that since the dividend paid deduction is intended to partially eliminate the double taxation of corporate earnings, to the extent that a second level of tax does not exist, the effect of the deduction should be eliminated by taxing the tax-exempt entity on dividends it receives.

In any event, there does not seem to be a good reason for determining the amount of the taxable dividend

to the tax-exempt organization solely on the basis of the corporate return as originally filed. If the corporation has a loss carryback which reduces its QDA in the carryback year, and thus loses its dividend paid deduction in that carryback year, the tax-exempt shareholder logically should be entitled to a refund of its dividend tax in the carryback year.

6. To offset the revenue loss from the dividend paid deduction, foreign shareholders are subject to an additional withholding tax on noneffectively connected dividends equal to the top corporate rate (36%) multiplied by the percentage of dividends that are generally deductible during the year. This tax applies to all corporate dividends, whether or not the dividend paid is in fact deductible. The withholding would apply, for example, where the dividend was not deductible because it exceeded taxable income (but not earnings and profits) or because it was paid out of current earnings (where accumulated taxable income since 1988 was negative).

The rationale for automatic additional withholding (regardless of whether there are offsetting tax benefits to the issuer) may be that withholding must be determined at the time the dividend is paid, and the issuer generally will not know until the end of the taxable year whether its QDA is sufficient to allow a dividend paid deduction.

Nevertheless, the result is a windfall to the Treasury to the extent that the issuer does not receive a dividend paid deduction. One possible solution would be to provide that if the corporation does not in fact receive the dividend paid deduction, it would be permitted to refund the amount of the excess withholding tax to the foreign shareholders, and such refunded amount would be a refundable tax credit on its own income tax return for the year in question. While this solution is technically feasible, we recognize that it would be very difficult to carry out because many shares are held in "street" names and obtaining the name of the beneficial owner would be expensive and time-consuming.

7. The Bill exempts from the additional withholding tax on dividends paid to foreigners any dividends paid to a resident of a country which has an income tax convention with the United States. The exemption extends beyond December 31, 1988 only if the Secretary certifies that the treaty in question has adequate provisions to prevent treaty shopping.

While we fully support the concept that the United States should not be a party to treaties that permit treaty shopping, we do not believe that the dividend paid deduction will prove to be a very effective device to force such renegotiations. If a treaty does not preclude treaty shopping, the effect after 1988 would be that U.S.

withholding tax on dividends would be reduced from 30% to the treaty rate, to which the new surcharge would be added. This slow and indirect effect may not be sufficient to give an incentive to treaty partners to renegotiate the anti-abuse provisions in their treaties.

IV. Reduction in Dividends Received Deduction.

The corporate dividends received deduction (already reduced from 85% to 80%) is further reduced by the percentage of dividends that generally are deductible in the year in question. After the full phase-in of the dividend paid deduction, the dividends received deduction will be 70%.

The reduced dividends received deduction applies whether or not the paying corporation in fact receives a deduction for the dividend paid. For example, the reduced dividends received deduction would apply to dividends paid out of earnings and profits in excess of the issuer's taxable income, or to pro rata stock redemptions that are treated as dividends under section 302.

Comment

While this rule is a serious exception to the partial integration concept, we do not know of any wholly satisfactory alternative. The obvious solution would be to tie the amount of the payee's dividends received deduction to the amount of the payor's dividend paid deduction. (As noted above, the Bill already reaches this result for dividends paid by controlled subsidiaries.) However, for proper reporting to shareholders, the issuer's deductibility determination would have to be made shortly after the end of its taxable year (and it would be

necessary to deal with the case where, for example, a dividend was paid in January by a calendar year corporation to a corporate shareholder with a January 31 fiscal year end).

Moreover, the issuer's deductibility determination would have to be final from the shareholders' point of view in order to avoid the need for amended shareholder returns if the issuer's determination turned out to be incorrect. Furthermore, the payor corporation would have to make a very technical determination affecting not only itself but also all of its corporate shareholders. If a mistake were made in that determination (which, given the complexity of the determination, is conceivable) the payor corporation could be sued by its shareholders.

V. Repeal of "Workout" Exception of Section 108 (e)(10)(C).

Under the general rule of section 108(e)(10)(A), added to the Code by the Tax Reform Act of 1984, if a corporation retires its outstanding debt by issuing stock in exchange therefor, then, in determining whether there is discharge of indebtedness income, the corporation is treated as having retired its debt for cash equal to the value of the stock it issued in the exchange. Section 108(e)(10)(B) excepts from this general rule a corporation in bankruptcy proceedings or any corporation to the extent that it is insolvent. Such corporations continue to be governed by prior case law, under which a corporation neither recognizes discharge of indebtedness income nor suffers any scale back in its available favorable tax attributes when it issues its own stock in satisfaction of its indebtedness.[4]

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[4] See Staff of the Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 (the "Joint Committee Report"), at 167-68.

Section 108(e)(10)(C) provides a rule similar to that of section 108(e)(10)(B) for negotiated informal "workouts" between a corporation and its creditors outside of the supervision of a bankruptcy court. Under section 108(e)(10)(C), a corporation in financial difficulty can avoid the recognition of income on the exchange of stock for debt even if the corporation is not insolvent or in bankruptcy proceedings, provided the following conditions are satisfied:

> (i) the exchange is intended to alleviate cash flow and credit problems that could lead to involuntary bankruptcy or insolvency proceedings within a 12-month period;
>
> (ii) the corporation notifies its shareholders of its financial difficulty and of the fact that it is engaged in a workout;
>
> (iii) the exchange results in the elimination of at least 25 percent of the corporation's debt, and
>
> (iv) the plan is approved by holders of more than 50 percent of that debt.

While sections 108(e)(10)(A) and 108(e)(10)(B) generally apply to transfers after July 18, 1984, the 1984 Act codified the workout exception of section 108(e)(10)(C) as part of the amendments to section 382 of the Code that were enacted as part of the Tax Reform Act of 1976 and, in 1984, were scheduled to go into effect in 1986. The sole reason for the delayed effective date for the workout exception was to insure that effective limitations on the

survival of losses following a change in ownership would be in place when the workout exception came into play.[5]

The 1976 amendments to section 382 went into effect on January 1, 1986. However, H.R. 3838 would repeal these amendments entirely.[6] Thus, while the 1976 amendments and, consequently, the workout excep- tion, technically are now in effect, the Bill retroactively eliminates the workout exception.

Comments

Since we assume that the Bill drafters believe that new section 382 imposes appropriate limitations on the survival of loss carryovers following a change in corporate control, the avowed purpose of delaying the effective date of section 108(e)(10)(C), we do not understand why those same drafters now propose to repeal the workout exception. Such a repeal will eliminate a useful tool that does not contravene any tax policy and yet allows financially ailing corporations to avoid the trauma of bankruptcy proceedings.

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5 See New York State Bar Association, Tax Section, Effective Dates of Tax Reform Legislation, Tax Notes, March 3, 1986, at 871 (the "Effective Dates Report").

6 Section 321(d)(1).

The repeal of the "workout" exception probably will not result in any substantial increase in tax revenue. If a stock-for-debt exchange of a troubled, but solvent, corporation is taxed, the corporation will simply be forced to find another avenue to deal with its shortfall, presumably by filing for bankruptcy reorganization. In effect, therefore, the repeal of the "workout" exception would force companies that reach negotiated composition agreements with their principal creditors to file in bankruptcy, simply to gain access to the stock-for-debt exception available to companies undergoing bankruptcy rehabilitation.

As drafted, the workout exception is not freely available to any corporation that wishes to utilize it, nor is it subject to abuse; it is carefully tailored so that it can be satisfied "only if it is reasonably related to the objective of avoiding a likely insolvency or bankruptcy proceeding." Joint Committee Report, at 168.

The requirements that a corporation must notify its shareholders of its financial difficulty and of the fact that it is engaged in a workout in order to avail itself of this exception ensures that only corporations facing imminent insolvency or bankruptcy proceedings would utilize this provision; a corporation would be unwilling to

publicly announce that it cannot meet its obligations if that were not, in fact, the case.

The requirements that the workout result in the retirement of at least 25 percent of the corporation's debt and that it be approved by holders of more than 50 percent of that debt ensure that this provision would not be utilized in order to reach individual arrangements with favored creditors.

While it is certainly national policy to foster the financial rehabilitation of corporations, we can think of no policy purpose that is served by a tax rule that encourages corporate rehabilitations to take place under the aegis of the bankruptcy courts. We believe, therefore, that any tax reform legislation that ultimately enacts new section 382 should also preserve section 108(e)(10)(C), to permit this provision to take effect for a period of time sufficient to observe its operation in practice.[7]

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[7] If, for reasons that we have not identified, the workout exception in its current form is perceived as being too broad in relation to the problem that it was intended to address, we suggest that the workout exception be retained, but limited to exchanges of nonvoting,

(Footnote cont'd.)

New section 382, as proposed by H.R.3838, will be the subject of a separate Tax Section report. In the meantime, we note that the 1976 Act's version of section 382 currently is in effect, and, under even the most optimistic legislative prognostications, will remain in effect for several more months. In light of the continuing uncertainty as to the law applicable to acquisitions of loss companies in 1986, we reiterate the recommendation of the Section's Effective Dates Report, that pre-1976 Act

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(Footnote cont'd.)

nonparticipating, nonconvertible preferred stock for debt. Because such preferred stock represents a senior claim on a fixed portion of a company's assets, the exchange would allow a corporation to achieve flexibility with respect to the debt service obligations on its existing debt without resulting in a shifting of value to the company's common shareholders (as may occur in the case of an exchange of common stock for debt); instead, the company's creditors simply would have maintained the original amount of their claim on the company's assets while allowing a "window" during which the Company could deal with its cash flow difficulties.

As a mechanical matter, the limitation of the workout exception to preferred stock would be uncomplicated. References to "stock" in section 108(e)(10)(C) would be amended to "preferred stock", and a definitional cross-reference would be added to incorporate the preferred stock definition of section 1504(a)(4) (relating to securities that are not treated as "stock" for purposes of the definition of an affiliated group).

section 382 be extended through 1986, and that, as in 1978, taxpayers be permitted to rely on 1976-Act section 382 in 1986 on an optional basis. Effective Dates Report, at 870.

VI. Amendment to Definition of Affiliated Group.

Section 1504(a), as amended by the Tax Reform Act of 1984, generally permits a subsidiary to join with its parent in filing consolidated federal income tax returns only if the parent and other affiliates own stock of the subsidiary representing at least 80 percent of voting power and 80 percent of value. For purposes of this affiliation rule, section 1504(a)(4) excludes from the definition of "stock" nonconvertible, nonvoting, nonparticipating preferred stock with certain redemption and liquidation features. (We refer to such stock here as "excluded stock".) Section 1504(a)(4)(C) currently removes from "excluded stock" categories preferred stock that has redemption and liquidation rights that exceed by more than a reasonable redemption premium the "paid-in capital or par value represented by such stock."[8A]

8A House Report, at 892. The apparent purpose of section 1504(a)(4)(C) is to treat as "stock" for affiliation purposes preferred stock that, by virtue of having redemption and liquidation rights substantially in excess of the shareholder's original investment, enables the shareholder indirectly to participate in the long-term growth of the corporate enterprise. New York State Bar Association, Tax Section, Committee on Corporations, Report on Tax Reform Act of 1984 Amendments to Section 1504(a), the Definition of "Affiliated Group", Tax Notes, Feb. 19, 1985 (the

(Footnote cont'd.)

The Bill would amend section 1504(a)(4)(C) by striking the reference to "paid-in capital or par value" and substituting the term "issue price." The accompanying House Report states that "[t]he amendment makes irrelevant the accounting treatment given the issuance of the stock."[8B]

Neither the Bill nor the accompanying House Report defines the term "issue price." However, section 1504(e)(1) of the Bill had its genesis in the Technical Corrections Bill of 1985 (H.R. 1800). The Description of The Technical Corrections Act of 1985, prepared by the

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(Footnote cont'd.)

"Section 1504(a) Report"), at 903. Under this analysis, section 1504(a)(4)(C) serves a role that is essentially similar to the requirement of section 1504(a)(4)(B) that, in order to qualify as"excluded stock", a preferred stock must "not participate in corporate growth to any significant extent."

[8B] House Report, at 892. The change proposed by the Bill is, in part, intended to make irrelevant the different definitions under the corporate laws of the fifty states of the terms "par value" or "paid-in capital." In addition, the proposed change is responsive to the concern that the current statute would not permit the recapitalization of a company's common stock into a new preferred stock qualifying for the "excluded stock" exception of section 1504(a)(4) in those circumstances where the issuer lacks sufficient statutory capital to meet the requirements of section 1504(a)(4)(C). See Section 1504(a) Report, at 902.

Staff of the Joint Committee on Taxation, April 4, 1985, amplified the proposed statutory change by stating that: "In general, the issue price of stock is its fair market value upon issuance." Id. at 15. Therefore, since neither section 1504(e)(1) nor the accompanying legislative history defines the term "issue price", and since in the somewhat analogous area of measuring unreasonable redemption premiums for purposes of section 305, the "issue price" of preferred stock generally is equivalent to its fair market value on issuance, we believe that the Bill's ambiguity might be resolved by resort to a fair market value standard. However, such an approach would have unintended adverse consequences for the financial restructuring of subsidiary corporations with outstanding third-party debt.

Consider, for example, the following hypothetical case. A parent corporation ("Parent") and its wholly-owned subsidiary ("Subsidiary") file consolidated federal income tax returns. Subsidiary, having suffered business and financial reverses, has negotiated a restructuring of its outstanding long-term debt obligations. Under this workout plan, Subsidiary's long-term creditors will exchange their debt claims against Subsidiary for a package of new Subsidiary equity securities, consisting of: (i) nonvoting, nonparticipating, nonconvertible preferred stock of Subsidiary with a relatively low dividend rate and a

redemption and liquidation value equal to the aggregate face amount of the creditors' current claims, and (ii) common stock of Subsidiary representing, after issuance, 20 percent of Subsidiary's outstanding common stock. The Subsidiary preferred stock will be mandatorily redeemable out of a specified percentage of Subsidiary's future net cash flow. Because the timing of those flows is not certain, and because the Subsidiary preferred will pay a relatively low dividend, the new preferred stock is expected to have a fair market value on issuance that is less than its redemption and liquidation value.

Such a restructuring is, we believe, consistent with the kinds of workout agreements regularly negotiated by creditors and corporate debtors. Subsidiary has relieved itself of an unmanageable debt service obligation. At the same, time Subsidiary's creditors have preserved their rights to the return of monies they originally advanced to Subsidiary as promptly as permitted by Subsidiary's operating cash flow. As compensation to the creditors for agreeing to forego their rights to press Subsidiary for immediate payment, Subsidiary and Parent, through the issuance of Subsidiary common stock to Subsidiary's creditors, have given those creditors a 20% interest in the long-term growth of Subsidiary.

Thus, Subsidiary's new preferred stock serves the purpose of deferring to the future Subsidiary's present obligation to repay its creditors, while removing from Subsidiary the specter of default on its debt obligations. The creditors must look to their Subsidiary common stock, not their preferred stock, for any participation in the future growth of Subsidiary.

Nevertheless, under the Bill approach, the preferred stock does not qualify for the "excluded stock" exception to the affiliation rules. As a result, Parent will no longer meet the ownership requirements of section 1504(a) and can no longer join with Subsidiary in filing consolidated federal income tax returns.

If, however, instead of issuing the above package of preferred and common stock, Subsidiary were to issue a new debt instrument having a nominal interest rate but a face amount equal to the face amount of its currently-outstanding debt, the result under section 1275(a)(4) would be that the "issue price" of the new debt would equal the face amount of the old debt.[9] Accordingly, Subsidiary would not recognize any discharge of indebtedness income, and, because third-party indebtedness is ignored for

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[9] We assume, of course, that the old debt was not issued at a discount.

purposes of the affiliation rules of section 1504(a), Parent and Subsidiary could continue to file consolidated returns.

We do not believe that any tax policy purpose is served by requiring Subsidiary in this case to issue debt rather than preferred stock to preserve tax affiliation with Parent. The purpose of section 1504(a)(4)(C) is to remove from the "excluded stock" exception to the affiliation rules disguised participating preferred stock. However, preferred stock issued in a recapitalization that seeks, in effect, to freeze a security holder's current claim against a corporation should not be characterized as disguised participating preferred stock. Such preferred stock's purpose is to cut off the holder's claim against the future growth of the enterprise by limiting that claim to its current level. The Bill would make impossible the recapitalization of existing third-party debt into preferred stock, unless the parties were able to predict with certainty the value of its new preferred stock. In negotiated workouts of corporations in financial distress, the parties typically would be unable to predict the marketplace valuation of the new preferred stock.

We believe that this problem can be resolved without vitiating the appropriate application of the "excluded stock" rules by revising the definition of "issue

price" in section 1504(a)(4)(C). It should contain a "floor" rule analogous to section 1275(a)(4)'s special definition of "issue price" for purposes of applying the original issue discount rules to bond-for-bond recapitalizations. Under this suggested approach, when a new preferred stock is exchanged for an outstanding debt instrument in a recapitalization or other reorganization, the "issue price" of the new preferred stock for purposes of section 1504(a)(4) would be deemed to be not less than the adjusted issue price of the old debt instrument exchanged therefor.10 (Consideration should also be given

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10 To implement this suggested definition of "issue price" in recapitalizations or other reorganizations, the amended Code or the legislative history should articulate an ordering rule for determining the "issue price" where (as in our earlier example) an outstanding debt obligation is retired for a package of new securities. To accomplish the purpose of the proposed definition of "issue price", the principal amount of the outstanding debt should be deemed retired for section 1504(a)(4)(C) purposes in the following order: first, the principal amount of the outstanding debt should be reduced, dollar-for-dollar, by any cash distributed; second, the remaining principal amount should be reduced by the principal amount of any new debt securities issued in the recapitalization exchange; and finally, the redemption/liquidation value of the preferred stock issued in the exchange should be applied against the remaining principal amount of the outstanding debt to determine the "issue price" of the new preferred stock. Under this ordering rule, so long as the redemption/liquidation value of a new preferred stock issued in a recapitalization is no greater than the principal amount of the old debt (reduced by any cash and

(Footnote cont'd.)

to adopting such a "floor" rule for purposes of the unreasonable redemption premium rules of section 305.)

The above proposal for a special definition of "issue price" in recapitalizations would conform section 1504(a)(4)(C) to the Code's definition of "issue price" for original issue discount purposes. The proposal would permit corporate subsidiaries to use preferred stock to recapitalize while continuing to file consolidated returns with their parent, so long as that preferred stock, in

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(Footnote cont'd.)

by the principal amount of any new debt issued in the exchange), the "issue price" of the new preferred stock would be deemed to be equal to its redemption/liquidation value, without regard to any common stock that might also be issued in the exchange.

This proposed ordering rule is similar in concept to, and would serve the same purpose as, the ordering rule contained in the legislative history to the Bankruptcy Tax Act of 1980 for applying the stock-for-debt exception to the discharge of indebtedness income rule for a recapitalization exchange involving a package of new securities. S. Rep. No. 96-1035, 96th Cong., 2d Sess. 17 (1980). In each case, the proposed ordering rule has the effect of facilitating the rehabilitation of distressed corporations and of avoiding difficult valuation issues. In the context of section 1504(a)(4)(C) and the example given earlier, any other ordering rule (for example, a rule that would require the allocation of the principal amount of the outstanding debt between the new preferred stock and new common stock based on their relative fair market values) would reintroduce the very valuation uncertainties that the suggested definition of "issue price" for recapitalization exchanges is meant to cure.

economic effect, would freeze at current levels a holder's claims against the issuing corporation. At the same time, a preferred stock with a true participation feature would continue to fall outside the "excluded stock" exception of section 1504(a)(4), just as a new bond issued in exchange for an old bond is subject to the original issue discount rules when the face amount of that new bond exceeds that adjusted issue price of the old bond.

VII. Code section 337/368 overlap.

The Bill codifies the result of General Housewares Corp. v. United States, 615 F.2d 1056 (5th Cir. 1980), if not its reasoning. The Bill determines that sections 336 and 337 are not applicable to transfers of property pursuant to a plan of reorganization. At the same time, the Bill provides a new rule, that gain or loss is not recognized on any disposition of stock or securities in a corporation that is a party to a reorganization if the stock or securities are received pursuant to the plan of reorganization. Thus, the Bill overrules the anti-taxpayer result of FEC Liquidating Corp. v. United States, 548 F.2d 924 (Ct. Cl. 1977).

The Bill also reverses the result of Minnesota Tea Co. v. Helvering, 302 U.S. 609 (1938), by providing, in effect, that gain is not recognized to a transferor of property in a reorganization when "boot" in the reorganization is not distributed to the transferor's shareholders -- for example, when a transferor of property in a "C" reorganization retains a liability and satisfies that liability with cash boot supplied by the acquiror.

Comments

1. We enthusiastically support the Bill's elimination of the trap for the unwary posed by Minnesota Tea. We are equally supportive of the Bill's resolution of

the overlap issue between the liquidation and reorganization provisions in a manner that permits the target in a "C" reorganization to retain a liability and use some of the acquiror stock it receives to satisfy that liability without gain to the target -- just as would have been the result had the acquiror assumed the liability and issued less stock to the target in the first instance. Since the principal effect of the amendment to section 361 is to permit a target corporation to satisfy a liability whose magnitude is disputed by the acquiror, which liability could have been satisfied by the acquiror without the recognition of gain if the acquiror had issued its own stock directly to the creditor, we do not believe that there is any inconsistency between the Bill's repeal of the General Utilities doctrine and this amendment to section 361.

2. By clarifying that sections 336 and 337 have no application to a corporation that is a party to a reorganization, the Bill ensures (whatever the fate of its repeal of the General Utilities doctrine) that a target corporation in a reorganization in which the target company liquidates will recognize gain on the distribution of any of its appreciated property as boot, because no Code section will protect the target from recognizing gain on

that property when the target liquidates as part of the reorganization.[11]

3. The Bill fails to address the problem of the corporate-level treatment of boot in certain non-liquidating reorganizations.

The distribution of appreciated boot in a reorganization or spin-off should be subject to corporate-level tax, in the same manner as are dividend distributions. The Bill's amendment would accomplish this result for reorganizations in which a target company liquidates (by precluding the application of sections 336 and 337), but fails to address important forms of both non-liquidating acquisitive reorganizations (section 368(a)(2)(E)) and non-acquisitive transactions (recapitalizations and spin-offs).

For example, consider a corporation ("P") that offers to issue to P shareholders in exchange for P stock a unit consisting of stock in a subsidiary ("S") and an undivided interest in appreciated property of P. If the exchange offer consisted solely of S stock, and the other

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[11] Since section 336 (and, by extension, 337) can be viewed as a codification of General Utilities, the statutory determination that section 336 does not apply to a corporation that liquidates in pursuance of a plan of liquidation should not be interpreted as a backhanded invitation to resurrect case law nonrecognition rules. This should be reflected in the legislative history.

conditions of section 355 were met, that exchange would qualify as a tax-free "split-off" to P shareholders, and P would incur no section 311(d) tax liability on the exchange. On the other hand, if P's appreciated property alone were distributed to P shareholders in redemption of P stock, the P shareholders would be taxed under section 302, and P would be subject to tax under section 311(d).

However, by combining the two distributions into a single exchange offer, P can maintain that it avoids the application of section 311(d). Under current law, it can be argued that section 311(d) does not apply to distributions of appreciated boot in a reorganization or spin-off because section 311(d) by its terms applies only to distributions to which Subpart A of Part I of Subchapter C (Code sections 301 through 307) applies. Although boot can be treated as a dividend, the taxation of boot is determined by the rules of section 356, which rules are not identical to the rules of sections 301 and 302. We believe that this arguable discontinuity in the Code should be remedied at the same time that section 361 is amended.

VIII. Corrections to the Golden Parachute Rules.

The Bill makes a number of substantive modifications to the golden parachute provisions of Section 280G. One change would permit exclusion from the parachute definition any payment made by a corporation if, immediately before a change in control, the corporation's stock was not readily tradeable on an established securities market. This rule could apply only if the payment is approved by shareholders owning more than 75% of the voting power of all outstanding stock (disregarding stock held by individuals receiving the payment).

Comments

1. The legislative history of Section 280G suggests that three abuses were perceived in golden parachute payments, all relating to harm to shareholders: the ability of management to line its own pockets at the expense of shareholders; use by entrenched management to preserve its control; and the incentive afforded by golden parachutes to encourage management to recommend takeovers not in the shareholders' best interests. Krueger, Opportunities and Pitfalls in Designing Executive Compensation: the Effects of the Golden Parachute Tax Provisions, 63 Taxes 846, 847 (December 1985). From this viewpoint, it is logical to exclude from section 280G

situations where the shareholders, by informed vote, have chosen to approve the golden parachute arrangement.

2. The introductory paragraphs of the House Report explanation, at 899-901, provide a summary of the present rules of section 280G. In a number of places, the rules as so summarized are by no means clear under the statute or its legislative history:

(1) The House Report states that a payment merely accelerated by a change of control is not a parachute payment if the present value of the payment is not increased (such as exercise of an already vested stock appreciation right). This appears to be inconsistent with the statement in the Conference Report to the 1984 Act, at 851, that a payment is a parachute payment if the change of control determines the time of payment.

(2) Example (2) of the Conference Report to the 1984 Act deals with a contract providing for severance payments upon termination of employment. The example indicates that if employment is terminated as a result of a change in control, the contract severance payment will be treated as a parachute payment. This has been thought to imply that any post-employment payment made to an executive terminated because of a change in control will be deemed a parachute payment. Kreuger, supra, at 852. The House Report, on the other hand, states that where a vested employee receives a pension benefit on a change of control, which benefit is not actuarially reduced to reflect earlier payment, only the excess present value of the benefit resulting from the failure to reduce, rather than the entire benefit, is treated as a parachute payment under present law.

(3) The House Report provides that compensation previously earned is generally to be treated as reasonable compensation. While this is unexceptional, the Report illustrates this point with accrued but unvested pension benefits, which are considered reasonable compensation (even if they vest on a change of control) to the extent of the probability that they would have vested by continued service in the absence of a change of control. This

"hypothetical probability of vesting" concept is entirely new.

We fully support these interpretations of present law. However, we question the method used to "adopt" these interpretations, namely a description of present law in a subsequent report. We believe it would be more appropriate for the statute to be changed to reflect these interpretations, with amplification if desired in the Report's description of changes.

3. We believe an additional technical correction is appropriate to clarify that grandfathered payments (i.e., those made pursuant to contracts binding on June 14, 1984) do not count against the threshold amount (three times the base compensation) in determining whether other payments are parachute payments.

IX. Nonliquidating Distributions of Partnership Interests by Corporations.

Section 1505(c)(1) of the Bill amends Code section 386 by limiting the gain recognized under section 311 by a corporation that distributes a partnership interest to its stockholders. Gain is limited to the amount that would have been recognized had the partnership interest been sold for its fair market value. A similar provision was contained in the House version of section 386 when it was first introduced in 1984, but was later dropped (without explanation) from the section as it was enacted.

Comments

1. The proposed "cap" on gain recognized under section 311 is a useful corrective to an anomaly that exists under current law. Under section 386 in its current form, if (i) a corporation were to purchase for $100 a 10% partnership interest from an existing partner, (ii) the partnership's aggregate "inside" basis were $500 of which the corporation's share was $50, (iii) no section 754/743 election were in place (and section 704(c) did not apply to the partnership's assets), and (iv) immediately after the purchase the corporation were to distribute that partnership interest to shareholders in a distribution described in section 311, then the purchasing corporation would recognize immediate gain of $50. By contrast, the

corporation would recognize no gain on an immediate resale of that partnership interest, even if all of the partnership's assets were section 751 "hot" assets.

We note, however, that, in at least one circumstance, the Bill will produce a result for a distributing corporation that is more favorable than an outright sale of a partnership interest. This anomaly is the result of the Bill's cap on recognized gain being determined by reference to aggregate gain, without regard to that gain's character.

A partner's sale of its partnership interest for an amount equal to its tax basis in that partnership interest can in general give rise to a tax liability where the partnership has section 751 "hot" assets because under section 751 the sale will be bifurcated into the sale of section 751 assets, giving rise to ordinary income, and the sale of other assets, giving rise to an equivalent amount of capital loss. Under the special basis allocation rule of section 732(d), however, the selling partner would not recognize any gain in respect of his interest in the partnership's section 751 assets if the sale took place within two years of purchase.

Thus, in our earlier example, the corporation that distributed a partnership interest would, by virtue of section 732(d), have recognized no gain if it had sold that

partnership interest. On the other hand, if the distributing corporation had acquired that partnership interest more than two years previously, and had sold, rather than distributed, the interest, section 732(d) would not apply, and the corporation could recognize ordinary income and offsetting capital loss. In such circumstances, the aggregate gain cap of the Bill would be zero, and the corporate partner would be better off distributing the partnership interest than selling it.

The House Report states that, under the amendment, "a corporation that acquired its interest by making a cash contribution to an existing partnership would recognize no gain if it immediately distributed the interest to its shareholders, regardless of the basis of the partnership property attributable to its interest." House Report, at 905 (emphasis added). This statement is true but hopelessly oblique: it compresses into a few words a complex problem of the interaction of the principles of the "ceiling rule" of the current section 704(c)(2) regulations, "reverse" section 704(c) allocations for partners admitted after the formation of a partnership when property has appreciated in value, and the determination of a partner's share of "inside" basis under the section 743

regulations.[12]

We are concerned that, as written, the sentence could be misunderstood to suggest that a section 386 issue is also raised under current law if a partner contributes cash in exchange for a partnership interest at the <u>inception</u> of the partnership and then distributes that partnership interest, which is not the case.[13] We suggest that, the subsequent legislative history to H.R.3838 as the Bill is considered by the Senate and by a House-Senate conference, either expand this thought to explain the issue to which it obliquely refers, or delete any reference to it.

2. Section 1505(c)(1) of the Bill also gives the Secretary authority to promulgate regulations to prevent

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[12] See, e.g., Memorandum dated January 8, 1986 from W. McKee et al. to Mark A. Kuller, titled "Administrability of Widely Held, Complex Partnerships and Mitigation of the Adverse Effect of the Ceiling Limitation", summarized in Tax Notes, January 27, 1986, at 303.

[13] The legislative history to section 386 states that a partner's share of partnership "inside" basis should be determined under the principles of section 751. Regulation section 1.751-1(a)(2) provides that a contributing partner's share of partnership "inside" basis should be determined by taking section 704(c) into account. The result would be that a partner that contributes cash at the inception of a partnership should have a share of partnership "inside" basis equal to that cash. Regulation section 1.743-1(b)(2), Examples (2) and (3).

the evasion of the anti-netting rule of section 311 through the contribution of high-basis, low-value property to a partnership to offset unrecognized gain in other assets. We note that, in the case of assets of the same character (ordinary or capital), the anti-netting rule can be avoided simply by selling the loss assets. Accordingly, we urge that the legislative history clarify that the regulations to be promulgated should focus on the most meaningful abuse pattern: The injections of depreciated capital assets into a partnership to offset unrealized ordinary income. In addition, we recommend that the legislative history make explicit that any such regulations should not apply to assets historically used by a contributing partner in a single trade or business -- for example, all the assets of a particular corporate division.

X. Amendment to Section 304.

Section 1575(b) of the Bill amends section 304 to provide that on a corporation's purchase of stock of a commonly controlled corporation, the hypothetical contribution to the capital of the purchasing corporation by a selling shareholder does not arise if the selling shareholder is entitled to capital gain rather than dividend treatment on the sale proceeds.

The provision reverses the result of Revenue Ruling 77-427, which held that such a stock acquisition did not qualify as a purchase under section 334(b)(2) (even though the end result was a cost basis to the acquiring corporation) because the purchaser's basis was determined by reference to the Seller's basis (i.e., carryover basis plus gain recognized to the seller). The result of the Bill will be to expand the circumstances in which section 338 (or whatever remains of section 338) will be applicable.

We strongly support the amendment. Section 304 was aimed principally at corporate bailouts at capital gain rates. The basis rule to the purchaser is simply a collateral consequence of the section 304 recharacterization, and will always in fact give the equivalent of a cost basis if the seller has capital gain under section 302. If the seller's percentage interest in the acquired corporation is reduced sufficiently so that the seller

qualifies for capital gain treatment, the bailout problem does not arise as to that shareholder and there is no abuse to be solved by treating the buying corporation as receiving a contribution to capital.

We believe, however, that the new rule should apply not just in the section 304 context, but also in the section 351 context where the selling shareholder's percentage interest is sufficiently reduced to satisfy the section 302 tests. To be sure, if section 351 (and not section 304) applies to a transaction involving the receipt of cash by selling shareholders, such cash will be capital gain in any event. However, as to the purchasing corporation, anomalies arise if the amendment applies solely in the section 304 context.

To illustrate, consider the situation where newly formed P will acquire all the stock of T. P and T have no common or related shareholders. The aggregate acquisition price for the T stock is $80 of cash and $20 worth of P preferred stock. The cash comes from $20 of equity contributed by the P shareholders to P simultaneously with transfer of T stock to P, and $60 of bank debt. The cash and preferred are distributed pro rata to T shareholders.

In this situation, section 304 applies to the receipt of cash by T shareholders (since T shareholders "control" P). Sections 304(b)(3)(A) and 304(c)(1). Under

existing law, P would be considered to have received 20% of the T stock in a section 351 exchange for P preferred stock, and 80% of the T stock in a section 304 contribution to capital. The T shareholders would all receive capital gain treatment on the cash received, since their constructive interest in T immediately after the transaction is exactly 50% of their interest in T immediately before. Section 304(b)(1). However, under Revenue Ruling 77-427, P could not make a section 338 election as to T. The Bill would change this result by treating P as having purchased 80% of the T stock, thus enabling P to elect under section 338.

Variation 1: The facts are the same except that the P shareholders contribute $21 (rather than $20) in equity and P borrows $59 (rather than $60).

Variation 2: P shareholders contribute $21, P borrows $60, and the preferred is worth $19.

In both variation 1 and Variation 2, section 304 does not apply because the value of the preferred received by the T shareholders is less than the value of the equity contributed by P shareholders. The T shareholders thus do not control P. As a result, the entire transaction is governed solely by section 351. All the T shareholders will have capital gain equal to the lesser of cash received

or realized gain, but P will not be eligible for section 338 even though at least 80% of the consideration was cash.

It should be emphasized that these results arise in the case where T shareholders receive proportionately less P equity than in the basic case (i.e., less than 50% rather than 50% or more). It makes no sense whatsoever for P to be required to give T shareholders at least 50% of its equity value in order to be eligible for section 338.

We agree with the result that a section 302 reduction in an interest in T on the part of a T shareholder should result in a purchase by P. The same rule should apply, however, to transactions governed solely by section 351, so that stock acquired for "boot" in that case also is considered purchased. It should not be necessary to bring a section 351 transaction within the 351/304 "overlap" in order to have section 304 (and thus the Bill provision) rather than section 351 apply and therefore allow "purchase" treatment under section 338.

The Bill is also not clear as to how P is to know whether a T shareholder qualifies under section 302 -- such knowledge obviously requires knowledge of actual and constructive beneficial ownership by all T shareholders. Moreover, in close cases, the Bill apparently permits P to take the position that T shareholders qualify under section

302 even though the shareholders may prefer to claim dividend treatment.