REPORT #538

TAX SECTION

New York State Bar Association

Report on Certain Corporate Provisions

Of H.R. 3838 as Passed by the Senate

By

The Committee on Reorganizations

July 17, 1986

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Attached letter dated 7/17/86 enclosing report of the Reorganizations Committee regarding comments on the proposals in H.R. 3838 sent to the following:

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

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

The Honorable J. Roger Mentz
Assistant Secretary (Tax Policy)
Department of the Treasury

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

TAX SECTION

New York State Bar Association

July 17, 1986

The Honorable Dan Rostenkowski
2232 Rayburn Building
Washington, DC 20515

Dear Representative Rostenkowski:

The enclosed report, prepared by the Committee on Reorganizations of the Tax Section of the New York State Bar Association, comments on the proposals in H.R. 3838 to revise the taxation of reorganization transactions.

Because of time constraints resulting from the imminent start of Conference Committee meetings, the report has not been considered by the Executive Committee of the Tax Section and thus represents the views only of the Committee on Reorganizations.

I hope the report proves useful to you.

Sincerely,

Richard G. Cohen
Chairman

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

REPORT #538

Report on Certain Corporate Provisions Of H.R. 3838 as Passed by the Senate

by

The Committee on Reorganizations
New York State Bar Association Tax Section

July 17, 1986

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

Committee on Reorganizations

July 17, 1986

Report on Certain Corporate Provisions of H.R. 3838 as Passed by the Senate

This report* comments on certain corporate provisions of H.R. 3838, as passed by the United States Senate (the “Bill”). References will be made to the Report of the Committee on Finance of the United States Senate, S. Rept. 99-213, 99th Cong., 2d Sess. (May 29, 1986) (the “Senate Report”).

Summary

1 Bill §613 (non-deductibility of stock redemption expenses). Amounts distributed to shareholders in, or in connection with, a redemption of stock generally should not be deductible, and the provision should confirm that. The provision should, however, be limited to payments to or for the benefit of shareholders in, or in connection with, redemption of stock, and there should be an exception for amounts constituting compensation deductible under section 83(h) or 421(b) of the Internal Revenue Code (the “Code”).

* This report was prepared by Richard O. Loengard, Jr. and Robert A. Jacobs, co-chairman of the Committee on Reorganizations. Helpful comments were received from William L. Burke, Herbert L. Camp, Richard G. Cohen, Dale S. Collinson Jay D. Gayner, Karen Murphy and Donald Schapiro. The report has not been approved by the Executive Committee of the Tax Section.

2. <u>Bill §614 (reduction in stock basis for non-taxed portion of extraordinary dividends</u>). The proposed reduction in basis should apply only (1) in respect of dividends in excess of earnings and profits accumulated while the taxpayer held its stock, and (2) during the first five years the stock is held by the taxpayer. If basis reduction cannot be confined to dividends in excess of post-acquisition earnings, then section 1059 of the Code should merely be amended to increase the present one-year holding period to five years. Reductions in basis below zero should not be triggered into income on non-recognition dispositions of stock. The provision should be effective on the date of enactment.

3. <u>Bill §632 (special allocation rules for certain asset acquisitions</u>). The Conference Committee report should make clear that the section 338 basis allocation rules in applicable asset acquisitions will be those prescribed under final section 338(b)(5) regulations. The provision should be effective on the date of enactment.

4. <u>Bill §637 (treating all redemptions of corporate-held stock as in exchange for stock</u>). The provision should not be included in the Bill. The issue involved should be studied further.

5. <u>Bill §1804(g) (amendment to section 361 of the Code</u>). The Committee generally supports the provision.

Section 361(b)(3), providing nonrecognition of gain or loss on the disposition pursuant to the plan of reorganization of stock or securities received by a transferor corporation in a “C” reorganization, should apply as well to “A”, “D” and "F” and reorganizations, and should apply to dispositions to creditors. Consideration should be given whether losses on dispositions outside the plan of reorganization (i.e., other than to shareholders or creditors) should be recognized.

6. Bill §1804(j) (parachute payments). Miscellaneous comments are made.

Discussion

I. Bill §613.

This provision is intended to prevent “a deduction for any amount paid or incurred by a corporation in connection with the redemption of its stock”. [emphasis added][*] The text of the Bill itself is equally broad, disallowing all deductions “otherwise allowable under this chapter...for any amount paid or incurred by a corporation in connection with the redem2tion of its stock”.[**]

Without commenting on whether amounts paid to shareholders in redemption of their stock are deductible

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[*] Senate Report, at 223.

[**] Proposed Code $162(b)(l).

under current law[*], we question whether a provision motivated primarily by a desire to deny deductions for expenditures incurred in connection with “greenmail” payments should govern expenditures incurred in connection with all stock redemptions. The Senate Report and the Bill language do not limit the provision to “greenmail” redemptions; it applies to all redemptions.

Nor is the provision limited to redemption payments; it applies to “any amount” incurred “in connection with” a redemption, thus denying fees and expenses attendant a redemption. While the expenses directly connected to a non-deductible redemption should be non-deductible[**], it is questionable whether, for instance, the legal and accounting fees and other expenses incurred in connection with an agreement for the future redemption of stock in a closely held corporation, such as on the death or retirement of a principal stockholder, should be non-deductible.

As another example, the Bill would seem to disallow a deduction for State income taxes incurred by a corporation if appreciated property is used to redeem its stock (whether or not greenmail is involved and whether or not the stock is publicly traded). For example, were a State tax law provision corresponding to section 311(d) of the Code applicable to a redemption, the gain

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[*] See, Five Star Manufacturing Co. v. Commissioner, 355 F2d 724 (5th Cir. 1966).

[**] See, Technical Advice Memorandum 8626001 (August 23, 1985).

recognized by the redeeming corporation would be subject to State income tax -- thus producing an expense incurred “in connection” with the stock redemption.*

The provision should, in our view, be confined to shareholder payments themselves. By reason of existing law**, expenses directly connected with the non-deductible payment should be non-deductible.

The Committee is also concerned that by reason of the very broad scope of the Bill and of the Senate Report language, deductions will be disallowed in unintended cases. For example, a redemption of stock from an employee (or former employee) may give rise to a deduction as compensation, either under section 83(h) or section 421(b) of the Code; there seems no reason why the statute should disallow such a deduction.***

We therefore recommend that the provision disallow deductions only for payments made by a corporation to or for the benefit of its shareholders

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* The limited exclusions provided, for mutual fund and Code $561 dividends and for interest, would support an expansive application of the new restrictions. See the Senate Report at 224.

** See, Technical Advice Memorandum 8626001, supra.

*** It is not clear that the provision does disallow the section 421(b) deduction, especially if the redemption price equals or exceeds the value of the stock when the option is exercised, but clarification is desirable.

in connection with a redemption of its* stock, other than deductions described in Code Section 83(h) and 421(b).**

Finally, the Committee questions the need for making this provision retroactive to February 28, 1986. As indicated above, its scope is broad, far beyond cases of "greenmail", and it will apply to many small, closely held companies. Retroactivity seems justified only if there is a substantial problem under existing law requiring an immediate remedy, and the provision is narrowly drafted to deal with that problem. This is not the case here.

II. <u>Bill $614</u>.

Bill $614 reduces the basis of a corporate shareholder that receives an "extraordinary dividend", without regard to the period of time the corporate shareholder has held the dividend-paying shares. Under present law (section 1059 of the Code), basis reduction applies only where the shares are disposed of less than one year after their acquisition.

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* Provision could also be made for disallowance where a taxpayer purchases stock of a related corporation. See Faber, letter of July 7, 1986, to David Brockway, reprinted in Tax Notes (Highlights & Documents) of July 11, 1986.

** Payments to shareholders "in connection with" a redemption would include payment of their fees, as well as payments in satisfaction of their other claims being asserted in the transaction.

As drafted, the impact of Section 614 is extremely broad. In general, an extraordinary dividend is defined as any dividend in excess of 10% of basis (or if higher, the fair market value) of the shares on which the dividend is paid. The corporate recipient pays tax on either no part (if section 243(b) applies) or 20% (if section 243(a)(1) applies) of the dividend, and the Bill would reduce the shareholder's basis in the dividend-paying stock by the untaxed amount of the dividend. (The reduced basis would be used only for purposes of determining gain or loss when the shares are dis2osed of; if the distribution exceeded basis, the resulting excess would not be currently taxed but would be taxed on disposition of the shares.) The provision would not apply when the payor and payee corporations filed consolidated returns; Treasury Regulation § 1.1502-32(b)(2)(iii) provides for a basis reduction when dividends are paid and the statute does not contemplate two reductions.*

We believe that if existing law is considered inadequate in this area, the most direct response would-be to expand the one-year period in Code section 1059 to, say, five years. Basis would not be reduced on account of extraordinary dividends in the five-year period if the taxpayer holds the stock for five years.

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* Senate Report, at 250.

A more appropriate way to deal with the problem, however, is to provide for a basis reduction for extraordinary dividends paid during the first five years of a corporate taxpayer’s holding of stock, but only as to dividends in excess of post-acquistion earnings.

First, it should suffice to have the basis reduction apply only to extraordinary dividends within the first five years of a holding. (By contrast with current law, this proposal would not result in a restoration of basis after five years; extraordinary dividends within the five-year period would reduce basis even if the five-year holding period were eventually met.) Surely a taxpayer holding stock for five years is not any longer in the situation to which section 1059 is aimed.

Second, the reduction in basis should apply only to earnings accumulated prior to the taxpayer’s holding period; generally only those earnings are reflected in basis. Post-acquisition earnings are not generally reflected in basis, and there is, therefore, no reason to reduce basis if those earnings are paid out.

> Example 1. X buys 100% of the stock of Y for $10. X and Y do not file consolidated returns. Y pays a dividend of $5 to X, of which, under the Bill, 20% or $1 is taxable.* One year later X sells *Y* for $5. During the year X held its Y stock, Y has no earnings.

Under present law X has a §5 capital loss, an inappropriate result. Under the Bill, X's capital loss is reduced to $1, a more appropriate result (because X has made no profit but has paid ordinary income tax on $1).

Example 2. The facts are the same as in Example 1 but X and Y file consolidated returns. The result is the same as in Example 1 except that the dividend attracts no tax and X has neither gain nor loss on the sale. This result also seems appropriate.

Example 3. Again X buys Y for $10. X and Y do not file consolidated returns. Over the next five years Y earns a total of $5, which it then pays to X as a dividend. X sells Y for §10.*

X has a gain of $4 on the sale, arrived as as follows:

Purchase Price		$10
Extraordinary Dividend	$5	
Taxable Dividend (20%)	1	
Basis Reduction		(4)
Basis		6
Sales Proceeds		10
Gain		$4

Example 4. The facts are the same as in Example 3, except that X and Y file consolidated returns. X has no gain on the sale, arrived at as follows:

Purchase Price	$10
Post-Acquisition Earnings, added to basis	5
Tax Free Dividend, deducted from basis	(5)
Basis	10
Sales Proceeds	10
Gain	$-0-

* Code $243(b) does not apply to dividends out of pre-acquisition earnings.

The difference in result in Examples 3 and 4, involving essentially similar taxpayers, seems inappropriate. Moreover, in Example 3, Y could change the result by paying out its earnings each year as current dividends (thus avoiding the payment of an extraordinary dividend). The resulting discrepancy only serves to emphasize that the provision applies to parent-subsidiary cases where the timing and amount of the dividend have no significant economic effect. Hence, in many cases this provision would be a trap for the unwary, in others it might force companies to file consolidated returns, while in still others it may produce unjust tax burdens.

The proposal departs from the precedents in the consolidated return regulations and in Code section 243(b) (relating to the 100% dividends received deduction) by failing to distinguish between dividends paid out of earnings and profits accumulated while the dividend recipient owns the stock on which the dividend is paid and dividends paid out of earnings and profits accumulated prior to the stock's acquisition, which might be presumed to be reflected in basis. In the latter case, as Examples 1 and 2 above indicate, a reduction in basis may be justified, but, in the former case, it normally cannot be.

Accordingly, we recommend that the provision not apply to dividends that do not exceed the recipient corporation’s pro rata share of the earnings and profits accumulated while it owns the stock.*

We recognize that the “proper” result - basis reduction for dividends in excess of post-acquisition earnings - requires complicated calculations of earnings and profits and tracing of distributions. If such complications are considered too great to justify adoption of this proposal at this time, then we strongly recommend that, in lieu of Bill S614 as drafted, the existing one-year period of Code section 1059 merely be extended to, say, five years.

On a more technical level, the Committee believes the deferred tax on distributions in excess of basis should not be triggered by a disposition of the shares on which the dividend was paid if that

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* Alternatively, the exception to the basis reduction rule might apply only to dividends paid out of profits accumulated after the recipient’s purchase of its stock in the payor, Such a rule would differentiate between a dividend paid shortly after purchase from prior accumulated earnings which are then replenished and a dividend which is delayed until after the accumulation of post-acquisition earnings. The Committee thinks it undesirable to so differentiate since the timing of the dividend in relation to the accumulation of earnings seems irrelevant. It would make no difference under the consolidated return regulations.

disposition is one which is otherwise tax-free under section 351 or section 354. Relief is especially desirable in non-acquisitive reorganizations under section 368(a)(l)(D) and section 368(a)(l)(F). The gain would then be recognized on a subsequent disposition of the stock or securities received in exchange for such shares.

Also, it should be made clear that, since the taxpayer's earnings and profits include the excluded part of the extraordinary dividend, the gain (or reduced loss) recognized on the disposition of the stock attributable to the basis reduction should not also be included in earnings profits.

Finally, Section 614 applies to dividends declared after March 18, 1986. The Committee questions whether the tax benefits these provisions restrict are so untoward that retroactive legislation is a necessary remedy, The Committee recommends that the provision be made effective on the date of enactment.

III. <u>Bill §632.</u>

The Committee recommends that the Conference Committee Report make clear that the relevant section 338 regulations, applicable under that section or under proposed new section 1060, are not necessarily those issued by the Treasury as temporary regulations §1.338(b)2-T. Thus, if after a hearing on the temporary regulations, the Treasury decides that an amendment to them is appropriate, the amendment should apply under section 1060 as well.

Section 632 applies to transactions after May 6, 1986. As in the case of section 614, the Committee recommends that the effective date be the date of enactment.

IV. Bill §637.

The Committee believes that a redemption constituting a dividend should not be recast as an exchange merely because a corporate shareholder is involved. (If the shareholder has a high basis for its stock, exchange treatment could be preferable to dividend treatment.) If the abuse being dealt with is obtaining a (largely) tax-free dividend without a basis reduction, then an amendment to section 1059 seems a more appropriate remedy. Accordingly, we recommend Bill section 637 not be enacted, and the matter be the subject of further study.

V. Bill §1804(g).

Section 1804(g) amends section 361 in a number of respects, including a provision that would fix the basis of property received by the transferor pursuant to the plan of reorganization as its fair market value (presumably on the date received by the transferor). Proposed section 361(b)(2). Under proposed section 361(b)(3), the transferor in a reorganization described in section 368(a)(l)(C) will recognize no gain or loss on the disposition (pursuant to the plan of reorganization) of any stock or securities of a party to the reorganization received in the reorganization, H.R. 3838 as passed by the House of Representatives had a similar provision. However, it did not give assets received by the transferor in the reorganization a fair market value value basis nor did it limit the exemption given dispositions of stock or securities received in a reorganization; the exemption applied to all dispositions without regard to the type of reorganization involved or whether the disposition was incident to a plan of reorganization.

The Committee endorses this proposal but has the following comments:

(a) The non-recognition provision of proposed section 361(b)(3) should apply to all types of asset reorganizations, including those described in sections 368(a)(l)(A), (D) and (F). While the problem is a limited one because of the fair market value basis rule of proposed section 361(b)(2), an asset-type reorganization can take place over a time period sufficient for the value of stocks and securities, especially if publicly traded, to fluctuate significantly.

(b) The limitation of section 361(b)(3) to dispositions “pursuant to the plan of reorganization” would seem to exclude some or all transfers to creditors. This seems inconsistent with the indicated desire to overrule Minnesota Tea Company v. Helverinq, 302 U.S. 609 (1938). Senate Report at 914. The Bill or, at least, the Conference Committee Report should make clear that transfers to creditors are for purposes of section 361(b)(3) deemed pursuant to the plan of reorganization.

(c) The House bill extended the exemption of proposed section 361(b)(3) to all dispositions of stock and securities of a party to the reorganization received by the transferor in the reorganization. While the Committee can see why gains on their disposition, other than to shareholders or creditors, should be taxable as the Senate Bill proposes, the transferor should not be allowed to claim a loss if the assets lose value after the reorganization exchange. For example, a transferor corporation holding shares after a reorganization might have the option of delivering them to its shareholders if the shares appreciated in value or of selling them at a loss if they depreciated. This unintended election can be avoided by adopting the House version of the amendment or providing that no loss will be recognized on a dis2osition of stock or securities.

VI. <u>Bill §1804(j).</u>

Section 1804(j) of the Bill would amend section 280G of the Code, relating to parachute payments, in a variety of ways. While generally favoring these changes, the Committee has the following comments on these provisions of the Bill and the accompanying Senate Report:

(a) The Senate Report, page 916, states that normally, absent regulations to the contrary, the vesting of an option will be treated as compensation for purposes of section 280G (even if not so treated for purposes of section 83) but the exercise of the option will not be treated as compensatory. We suggest the Conference Committee Report make clear that a payment received by an employee in cancellation of a vested option will not be considered compensatory for purposes of section 280G.*

(b) The Senate Report, at 917, states that "Solely for purposes of the parachute provisions, severance payments would not be treated as reasonable compensation because such

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* It is not clear how one applies section 280G, which disallows a deduction if the event giving rise to the disallowance and presumably fixing its amount, <u>i</u>.<u>e</u>., the vesting of the option, gives rise to no deduction for income tax purposes. Unfortunately the technical amendments to section 280G do not address this problem. See *The Golden Parachute Provisions of TRA '84, Report of the Committee on 'Golden Parachutes' of the New York State Bar Association Tax Section (the "Tax Section Report"), reprinted in <u>Tax Notes</u>, Vol. 27, Number 8 (May 20, 1985), at 949, especially the discussion at 956.

payments are not made as payments for services rendered or to be rendered.” The Committee believes this statement to be in conflict with the normal conduct of twentieth-century U.S. employers; some form of severance pay is customary, whether or not pursuant to a contractual obligation, and is considered compensation for past services. Hence, we would urge that the Conference Committee Report disapprove this statement. If it does not, it should be made clear that this “rule” - a novel interpretation of a penal statute - should not be applied retroactively. There is no support for this rule in the statute itself, nor in prior committee reports on section 280G. A retroactive announcement of this rule is manifestly unfair.

(c) The rules limiting application of the statute to closely held corporations are welcome. However, it is regretable that the S Corporation definition has been taken over in its entirety, without regard to the special problems that caused the drafters of subchapter S to deny S Corporation status to corporations with foreign shareholders, more than one class of stock, etc. The Committee believes the purpose of the provision would be better served if it applied to any corporation with 35 or fewer shareholders. That is, section 1361(5) should be applied without reference to subsections 1361(b)(l)(B), (C) and (D); however, a corporation that would not be able to qualify under proposed section 280G(b)(5)(A)(ii) because its stock forms a substantial portion of the assets of a publicly traded entity should also not be able to qualify under this provision.

The provisions of proposed section 280G(b)(5)(A), providing for shareholders' approval in certain cases, are to be available retroactively. Senate Report at 921. Further guidance as to how approval is to be demonstrated would be helpful. For example, can it be by written consent of 75 percent of the shareholders (provided adequate disclosure is now made) without a vote or compliance with State corporate law requirements for a shareholders' action? Compliance with governing State rules years after the relevant stock has been sold may prove difficult or even impossible. Can an executor sign for a deceased shareholder and, in the absence of an executor, can an heir sign?

Proposed section 280G(b)(5) provides that a special rule may be established - the Senate Report, at 918, suggests that it should be established - if the stock of a corporation constitutes a “substantial portion” of the assets of a corporation the stock of which is publicly traded. A reference to a “substantial portion” of the assets of a corporation is also found in section 280G(b)(2)(A)(II). Its meaning is not clear and should be clarified in the Conference Committee

Report. There is precedent, under section 341(b)(l) prior to its amendment in 1984, for treating one-third as a "substantial part". The Conference Committee Report might provide that a similar percentage be applied in interpreting these provisions.

(d) The Senate Report, at 919, explains that "reasonable compensation" can include damages for breach of an employment contract if three conditions are met. The intended scope of these conditions should be clarified. Principally, condition (2) mandates that the individual must "offer to work"; it should be made clear that he need not offer to do work not commensurate with his prior status with the company or for compensation less than he has been receiving. In addition, if the suggestion in the Senate Report that severance pay can never be "reasonable compensation" is eliminated or modified, as subparagraph (b) above recommends, then the last sentence of the discussion of "reasonable compensation" on page 919, stating that damages for failure to make severance payments cannot be "reasonable compensation", should also be modified. The Committee believes that, at least where the termination of employment is involuntary and mitigation is provided for, damages for failure to make a severance payment may be "reasonable compensation" for prior services.

(e) Although "highly compensated employee" is defined, it is not clear how it applies to a consolidated group. Proposed section 280G(d)(5) provides that an affiliated group is treated as one corporation for purposes of "this section", presumably referring to section 280G as a whole. Proposed section 280G(c) includes the following:

> "For purposes of paragraph (2), the term 'highly-compensated individual' only includes an employee (or a former employee) who is a member of the group consisting of the highest paid 1 percent of the individuals performing personal services for the corporation or, if less, the highest paid 250 individuals of the individuals performing services for the corporation <u>or for each corporation that is a member of an affiliated group described in paragraph (5)</u> of subsection (d)." [Emphasis added]

Apparently, in a consolidated group, the 1% test is applied to the group as a whole. It is not clear whether the 250 individuals' test is similarly applied and, if so, what the words "performing services...for each corporation that is a member of an affiliated group ..." mean. The Committee believes that all tests should be applied to the consolidated group as a whole.

Relief should be given to small shareholders, to whom the parachute payments rules now apply without regard to their level of compensation. We suggest the Conference Committee Report direct that the Regulations include an exception for shareholders who own less than a specified percentage or dollar amount of stock (and who are not officers or highly compensated).[*]

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[*] <u>See</u>, Tax Section Report, at 954.

(f) The Senate Report and the Report of the Ways and Means Committee of the House (the “House Report”) on H.R. 3838 are not parallel. The Conference Committee Report should state which, if any, portions of the House or Senate Reports it does not accept and explicitly reaffirm the remaining portions. In particular, the last sentence of the House Report on this provision (under “Effective Date”, at 903) is not repeated or disavowed in the Senate Report and should be reconfirmed by the Conference Committee Report. The last sentence on page 900 of the House Report under the heading “Application” also is not repeated in the Senate Report. Its status should also be clarified. If the rule is intended, the Committee recommends that the Conference Committee Report clarify when forth is purpose a contract “becomes operative”; for example, it is not clear whether it is when services are first rendered pursuant to the contract, when there is a change in control or ownership and the right to a parachute payment vests, or when vested rights are accelerated.